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PART. B.

1989 BUDGET EMPLOYEE
SHARE OPTION SCHEMES

8.3.89

FROM: J M G TAYLOR
DATE: 6 February 1989

PMP

MR N WILLIAMS - IR

cc PS/Chief Secretary
PS/Financial Secretary
Mr Odling Smee
Mr Culpin
Mr Bent
Mr Neilson
Mr Flanagan
Mrs Chaplin

APPROVED EMPLOYEE SHARE SCHEMES: TAKE-UP

The Chancellor was grateful for your note of 31 January.

J M G TAYLOR

BUDGET CONFIDENTIAL

Tony Mr Stray

FROM: R C M SATCHWELL

DATE: 6 February 1989

MR N WILLIAMS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Culpin
Mr Odling-Smee
Mr Peretz
Miss Anderson
Miss Hay
Mr Neilson
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Farmer - IR
PS/IR

APPROVED ALL-EMPLOYEE SAYE SHARE OPTION SCHEMES

The Financial Secretary was grateful for your minute of 3 February. He agrees with your recommendation that the increase in the SAYE monthly limit should be implemented using the Finance Bill route, implying an effective start date for the new limit of 1 September.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Pro pl.
(Pre-emption rights)

CREDIT SUISSE FIRST BOSTON LIMITED

2A GREAT TITCHFIELD STREET LONDON W1P 7AA

FROM
SIMON E. PRIOR-PALMER
EXECUTIVE DIRECTOR

-9 FEB 1989

8 February 1989

FINANCIAL SECRETARY	
REC.	-9 FEB 1989
ACTION	Mr Ilett
COPIES TO	PS/Chancellor 2
	Mr Odling-Smee
	Mr Neilson
	Mr Farmer - IR

Mr. N. Lamont, MP
Financial Secretary to the Treasury
H M Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

Dear Mr. Lamont,

It was a pleasure to meet with you and your colleagues on 2nd February to review the issues in regard to the disapplication of pre-emptive rights.

I promised to revert to you to expand upon Jack Hennessy's comments at lunch in respect of constraints on employee participation. On an overall basis Jack was comparing employee participation in the UK to the US where there are no restrictions. The specific 'regime' in the UK is set out below.

General

Share Option and Profit sharing incentive schemes are governed by Investor Protection Committee ("IPC") guidelines. The Association of British Insurers ("ABI") is the most stringent and vociferous of the IPCs in this area. The IPCs believe that such schemes should provide a clear community of interest between employees and shareholders and this is best achieved by the grant of limited options only over the currently authorised share capital.

Employee Share/Share Option Schemes

The aggregate share capital issued by a company under all share option or profit sharing schemes within the preceding ten years must not exceed 10 per cent. of the ordinary share capital of the company at any time when a participation is granted. All schemes must normally provide that not more than 3 per cent. of the equity capital may be appropriated for options or subscribed out of profits under all relevant schemes in any year and the two preceding years (this restriction is sometimes released to allow the appropriation of 5 per cent. in 5 years). The ABI advise that the granting of options should only be made if there has been real growth in a company's EPS.

cc: PS/IR.

Share Capital in a Subsidiary Company

Arrangements which involve the grant of options over the share capital of a subsidiary company will be opposed by the IPCs unless the grant is in the case of either an overseas subsidiary whose employees would be precluded by local legislation from participating or, in the case of a UK subsidiary, at least 25 per cent. of its ordinary share capital is quoted on a recognised exchange and held outside the group.

A Case Study: The Burton Group PLC

The Burton Group PLC ("Burton") has an employee profit sharing incentive scheme and two share option schemes. They operate under the guidelines outlined above and illustrate the current limits to such schemes.

a) The Burton profit sharing incentive scheme is limited to 5 per cent. of share capital over a ten year period and is determined by reference to the salary of an individual. Shares are allotted to employees of over 3 years service (approximately 35% of the workforce) with a value equivalent to 3-4% of salary.

b) The Burton share option scheme is split into two:

    (i) The Executive share option scheme; and
    (ii) The Special share option scheme.

   Each scheme is limited to 5 per cent. of share capital over a ten year period and is determined by reference to total remuneration and is available to the top 250 employees. The share options under the Executive scheme can be granted up to a value of 4x total remuneration. Share options under the Special scheme can be granted up to a value of 8x total remuneration.

   In order for the options to be exercised there are three criteria which have to be met:

    (i) individual performance targets set by the Burton executive directors;
    (ii) group EPS to have outperformed the RPI by over 30% over 3 years;
    (iii) group EPS over any five year period following the date of grant has been such to place Burton in the top quartile by reference to the growth in EPS of the FTSE 100 companies.

The combined criteria are very demanding. Burton suffered extremely awkward and complex negotiations with the IPCs to achieve the above plans. The result was beneath their objectives. The entire matter is extremely confidential since Burton wish to renegotiate the schemes with the IPCs and the new negotiations will be highly sensitive.

We hope this letter is helpful and look forward to the opportunity to assist you further in this or any other matter.

Yours sincerely,

Simon Fein-Palmer

cc: Nicholas Ilett - Assistant Secretary fp.nh/mh/39 **BUDGET CONFIDENTIAL**

FROM: MISS M HAY
DATE: 10 February 1989

1. **MR GILHOOLY** DG 10/2
2. **FINANCIAL SECRETARY**

Subject to FST's views, I wd favour looking in terms of the consultation package in 1990.

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Odling Smee
Mr Scholar
Mr Culpin
Mr Peretz
Miss O'Mara
Miss Anderson
Mr Neilson
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins - Parly Counsel
Mr J Isaac
Mr C Corlett
Mr Painter (IR)
Mr Lewis
Mr Bush
Mr A Walker
Mr N Williams
PS/IR

STARTER 112: REVIEW OF EMPLOYEE SHARE SCHEMES

Our annual lollipop trawl has turned up a measure which both FIM and MG favour.

2. You have agreed that the Finance Bill should include an increase from £100 to £150 in the monthly limit on the sums which attract tax relief under the share option-related SAYE schemes which are run by the building societies on exactly the same terms as DNS.

3. There are two types of SAYE scheme: both are based on a savings contact over 5 to 7 years with a bonus at full-term. Both benefit from tax relief in the form of tax-free roll up. The original SAYE relief is restricted to savings of up to £20 per month. These SAYE contacts were offered by DNS until around 1984 but are no longer offered. Although this relief was primarily aimed at getting more funds into DNS it was extended to Building Societies and some still run these schemes. The share option

related schemes also attract tax-free roll-up but on a much larger scale. (The maximum permitted being £100 per month - £150 post-Budget).

4. In the past the Banks have pressed for extension of relief to cover SAYE schemes offered by them. Extension was last considered in 1985 but the matter was held over for subsequent review because share option schemes were then under review. The Revenue have recently completed a comprehensive review of the employee share scheme legislation and Ministers have taken decisions in the light of their conclusions; it would now seem an appropriate time to re-open the question of extending relief to banking schemes.

5. Extending the share-option SAYE tax concession to the banks should cost very little, if anything - it may simply take business away from others - and would fit in with the Government's "level playing field" policy in relation to banks and building societies. (Indeed, the current distinction will be highlighted if and when the Abbey National becomes a Plc, since any new schemes the Abbey offers thereafter will not attract tax relief). The extension would be welcomed by the banks, but not by the building societies (who would inevitably lose some business). Others, such as insurance companies, might plead to be included too, but it should be possible to hold the line.

6. If Ministers wanted to consider extension of the concession to banks further work would be required on how far that would go. The definition of a bank ("authorised institution") in the Banking Act goes very wide and we would need to decide where to draw the line (whether round the "high street banks" or slightly wider). If we drew the line widely - well beyond the major clearing banks- then we would also need to consider what policing would be required.

7. There is no case for extending the more general SAYE relief to the banks. This relief has become anachronistic - it was aimed at DNS who no longer need it, and the amount of relief available is very limited. If anything, there is a case for withdrawing the relief for all new non-share related SAYE schemes.

8. At first sight, extension of the relief for share-option SAYE schemes looks like a possible starter for this year; it could be hung on the coat tails of the other share scheme measures. Preliminary analysis has however identified a number of issues to be resolved - most importantly - the extent of any widening of its scope and the future of the smaller, general SAYE relief. If these issues prove less than straightforward, it may now be too late to get a measure into this year's Budget. But if Ministers are attracted by the proposal, the Revenue could undertake a quick fuller analysis of the work required (both legislative and administrative) and see whether FB 1989 is a possibility. If we were to legislate this year, however, that might exclude the option of abolishing the non-linked SAYE (which could be regarded as an anti-savings measure). Any package including abolition would be better deferred to 1990.

9. In view of the questions which would need to be considered would Ministers wish the Revenue to pursue the possibility of a starter this year to extend linked SAYE to banks; or would they prefer further work to be undertaken in the Autumn with a view to a Budget starter next year covering:

- possible withdrawal of the non-linked SAYE relief.

- extension of the linked SAYE relief to Plc Building Societies and banks.

MH

MISS MARY HAY

FROM: J M G TAYLOR
DATE: 13 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Odling-Smee
Mr Culpin
Mr Peretz
Miss O'Mara
Miss Anderson
Mr Gilhooly
Mr N Williams
Mr Neilson
Miss Hay
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins - Parly Counsel

Mr Isaac - IR
Mr Corlett - IR
Mr Painter - IR
Mr Lewis - IR
Mr Bush - IR
Mr A Walker
PS/IR

STARTER 112: REVIEW OF EMPLOYEE SHARE SCHEMES

The Chancellor has seen Miss Hay's note of 10 February.

2. Subject to the Financial Secretary's views, he would favour thinking in terms of the <u>combined</u> package in 1990.

J M G TAYLOR

PnP

CREDIT SUISSE FIRST BOSTON
LIMITED

14 FEB 1989

2A GREAT TITCHFIELD STREET LONDON W1P 7AA

FROM
SIMON E. PRIOR-PALMER
EXECUTIVE DIRECTOR

FINANCIAL SECRETARY	
REC.	14 FEB 1989
ACTION	Mr Ilett
COPIES TO	PS/Chancellor 2
	Mr Odling-Smee,
	Mr Neilson
	Mr Farmer - IR, PS/IR,

13 February 1989

Mr. N. Lamont, MP
Financial Secretary to the Treasury
H M Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

Dear Mr. Lamont,

Re: Employee Share Ownership

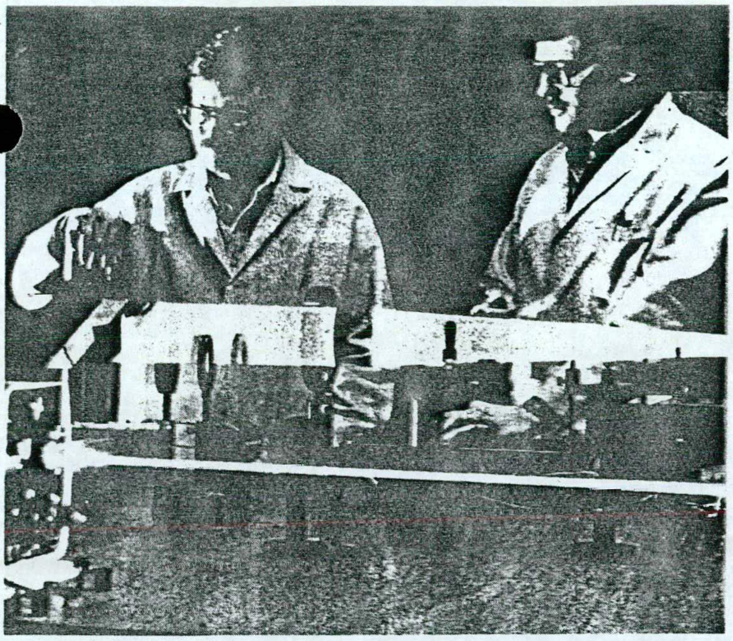
Further to my letter of 8 February I enclose an article from Time magazine, 13 February, 1989, that provides a succinct overview of the relative extent of employee stock plans in USA, Japan and the UK.

Kind regards,

Yours sincerely

Simon Prior-Palmer

cc: Nicholas Ilett - Assistant Secretary



POLAROID

In response to a hostile bid, management adopted an ESOP strategy that was supported by two-thirds of the company's 8,700 workers

ROADCHEF

A trust borrowed $2.3 million to buy 12% of the shares for employees, one of Britain's first ventures of its kind

Business

They Own the Place

Employee stock plans are hot in the U.S. and start to catch on worldwide

BY FREDERICK UNGEHEUER

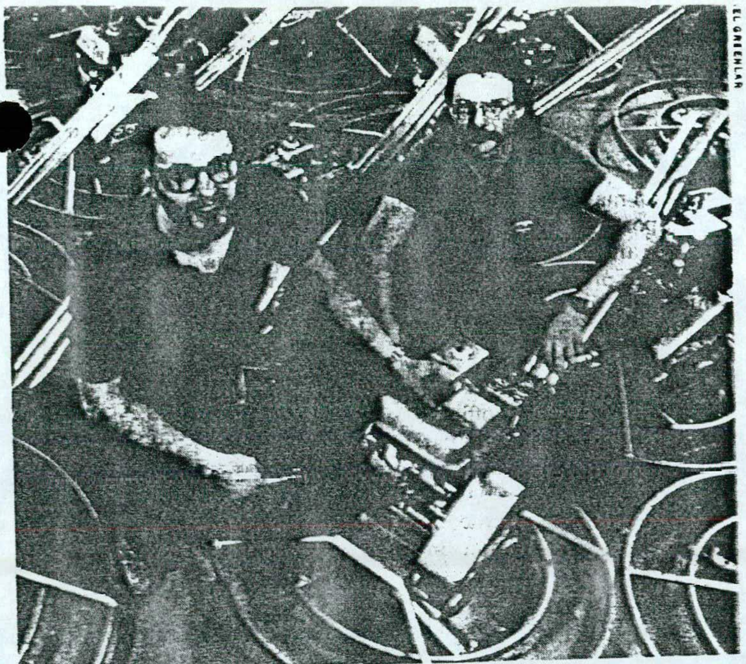
In thousands of U.S. companies large and small, the employees are starting to act as if they own the place. Well, they're entitled, because they do. Meet the new breed of hard-driving capitalist: the employee stockholder. At Oregon Steel Mills in Portland, the chairman's secretary has earned $500,000 in company stock, and a few of her colleagues have become paper millionaires. At Quad/Graphics, a Wisconsin printing company, the average five-year employee owns shares worth $250,000. In Avis car-rental offices across the U.S., employees are touting their stake in the company with lapel buttons that put a new twist on their old "We Try Harder" slogan: OWNERS TRY HARDER.

Employee stock-ownership plans, or ESOPs, are rapidly gaining adherents among corporate managements in the U.S. and are beginning to catch on in Western Europe and Asia. Ten million U.S. workers, about one-fourth of all corporate employees, are enrolled in an ESOP, up from 3 million only a decade ago. More than 9,800 American companies offer such programs, including 1,500 in which employees own the majority of the stock. By giving workers a stake in the company's success, enthusiasts say, the programs boost morale and productivity. But the popularity of ESOPs, which date back to the 1950s, has been fueled in the 1980s by an unintended and somewhat controversial application: as a double-edged tool useful for both financing corporate takeovers and staving them off.

Thanks to hefty tax breaks that Washington allows for ESOPs, investors who launch a takeover can reduce their borrowing costs if they set aside part of their stock for employees. At the same time, U.S. corporations seeking to repel raiders can use an ESOP as a way to put a chunk of the company into relatively friendly hands. "Every corporate treasurer is looking at it," says Paul Mazzilli, a principal at the Morgan Stanley investment firm. In recent months, three major corporations—J.C. Penney, Ralston Purina and Texaco—spent a total of $1.75 billion on ESOPs to shore up their takeover defenses. Procter & Gamble announced plans in January to spend $1 billion to boost its ESOP from 14% of outstanding shares to 20%, partly to ward off raiders.

The most hotly contested use of an ESOP is at Polaroid, which has put 14% of the company's stock into employee hands as a defensive ploy in its bitter six-month battle against a takeover bid by Shamrock Holdings. Because Massachusetts-based Polaroid is incorporated in Delaware, where an anti-takeover law requires that bidders must get 85% ownership of a target company to gain control, the ESOP is leaving Shamrock with almost no room to maneuver. When a Delaware court rejected Shamrock's challenge to the ESOP, Polaroid's workers "jumped up and down with joy," said Nicholas Pasquarosa, chairman of the employee committee. Shamrock is appealing the decision.

Pioneered by Louis Kelso, a San Francisco lawyer and economist, ESOPs were slow to catch on. But Kelso began to create a fertile financial climate for them



STONE CONSTRUCTION EQUIPMENT

Assemblers and engineers formed a partnership to boost the quality of a new line of power trowels, which increased the profit margin 10%

OREGON STEEL MILLS

Since employees bought the company in 1984, they have cut the time it takes a worker to make a ton of steel from nine hours to three

by enlisting the support of Russell Long, the populist U.S. Congressman from Louisiana. Before retiring from the Senate Finance Committee in 1986, Long initiated more than 20 bills to encourage creation of ESOPs.

One tax incentive allows a company sponsoring an ESOP to deduct not only the interest on the loan to buy stock for the plan but also the principal. Another tax break gives banks and other lenders a 50% deduction on income from ESOP loans, enabling them to charge lower interest rates to companies that borrow for such programs. Because Kelso's method of paying for the stock-purchase plans was to borrow against corporate assets, ESOPs gave rise in the U.S. to the leveraged buyout. But Kelso never intended his technique to be used for buyouts that would put all a company's stock in the hands of a few investors and top managers. "That is a perversion of my idea," says Kelso, 74. "Instead of making economic power more democratic, they make it more plutocratic."

The idea of mixing ESOPs and leveraging, thereby giving ordinary employees the same access to capital and credit enjoyed by people who control companies, has been exported only to Britain. Roadchef, a caterer to highway restaurants, borrowed $2.3 million two years ago to buy 12% of the stock for its employees. It has since added a further 15%. Just as in the U.S., the shares are held in a trust and distributed to employees as the loan is paid off. But there are only 14 companies, involving about 20,000 workers, that have experimented with ESOPs in Britain. All of them were privately owned previously, and British tax law does not yet recognize the concept.

In Japan employee stock-ownership plans began to take off in 1968 as a means of fending off foreign buyers. Today 1.738 companies, more than 90% of all firms listed on Japan's eight stock exchanges, have some kind of ESOP. But these have rarely granted more than 1% of their shares to employees and have never borrowed money to buy the stock for them. In Japan, says Koji Danno, chief of the employee-savings service at Nomura Securities, "the company becomes a father giving part of his savings to his children." For the 2.2 million Japanese employees with shares in their companies, the average holding amounts to $12,200.

In West Germany, where employee stock ownership is subsidized by the government, the average holding is nonetheless lower than in Japan, because annual allotments are limited to $500 per employee. But even those small stakes have lifted employee morale. The plan is aimed at strengthening the equity base of West German firms and making worker participation in management more meaningful.

If a company thrives, ESOP participants can accumulate a nest egg far beyond the means of most wage earners. At Wisconsin's Quad/Graphics, which prints hundreds of catalogs and magazines, including a regional edition of TIME, the value of ESOP shares has risen from 6¢ each in 1975 to $5 currently. In the case of Stone Construction Equipment, a small firm in Honeoye, N.Y., annual revenues have jumped from $12 million to $30 million in two years, and the loan to buy the company's $4.5 million worth of shares will be paid off out of profits in ten years. But for all their promise, ESOPs can mean sacrifices for workers. In many instances, U.S. employees have accepted wage concessions in return for their stock. The United Steelworkers of America has saved dozens of failing mills in such wage-for-stock trade-offs. In distressed industries faced with low-wage foreign competition, says James Smith, a U.S.W. staffer in Pittsburgh, "one of the ways American workers can compete is by having some investment income along with a lower labor income."

The ESOP surge has raised some eyebrows in the U.S. Congress. For one thing, ESOPs were never intended as a way for corporate managers to entrench themselves against takeover bids or for corporate raiders to enrich themselves. For another, the cost of providing the tax breaks is running as high as $3 billion a year, when deficit cutting is urgently needed.

But in Washington the ESOP seems politically secure for now, while in Britain a growing number of politicians on both sides of the House of Commons support the concept and would like employees to be cut in on Margaret Thatcher's program for selling off publicly owned enterprises. Even China's Communist reformers are studying the ESOP as a possible way to boost workers' competitive spirit. —*Reported by Seiichi Kanise/Tokyo and Peter Shaw/London*

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: MS J FAIRFIELD
14 February 1989

FINANCIAL SECRETARY

PAYMASTER GENERAL

STARTER 115 - MATERIAL INTEREST

1. This note reports progress in the drafting of the material interest relaxation agreed by Ministers and in particular on the outcome of our confidential discussions about the proposed changes with the John Lewis Partnership (JLP) (Mr Satchwell's note of 21 December 1988).

2. The profit-related pay (PRP) and employee-share scheme (ESS) legislation provides that no employee with a material interest in a company may participate in that company's PRP or ESS scheme. In determining whether an employee has a material interest the interest of his associates must be taken into account as well as his own interest, if any. The definition of associate includes the trustees of a trust in which an employee has an interest. So in the case where shares are held in a trust set up for the benefit of employees, each employee is regarded as being interested in all of the shares in the trust by virtue of his

---

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Burr
Mr Gilhooly
Mr Ilett
Mr Tyrie
Mr Jenkins (OPC)
Mr Painter
Mr Lewis
Mr Creed
Mr O'Connor
Mr Farmer
Mr O'Hare
Mr Pardoe
Mr Ohrnial
Mrs Majer
Ms Fairfield
Mr Annys
PS/IR

"association" with the trustees. The effect can be to give an employee a material interest in his company, as is the case with JLP. The proposed relaxation involves excluding trustees from the definition of associate provided the trust satisfies certain conditions and provided the trustees do not in practice make distributions to any employee with a material interest, even though they may have the power to do so.

John Lewis Partnership

3. We met JLP on 23 December to explain the proposals. After some delay JLP have now agreed that the proposals solve their problem except for one difficulty. It arises from the structure of their trust which is extremely unusual, possibly unique. As a result, it does not satisfy the definition of the type of trust to which the proposed relaxation would apply. The essential features of the definition are that the trust should be one under which

- only individuals can benefit (with the sole exception of charitable organisations), and that

- all or most of the company's employees must be eligible to benefit.

4. The JLP trustees are obliged in certain circumstances - which have not arisen and are not likely to do so - to make payments to holders of JLP preference shares. They also have the power in the same circumstances to make payments to holders of JLP ordinary shares. Many of the preference shares are held by financial institutions, and as a result the JLP trust does not satisfy the "individuals only" requirement. (All the JLP ordinary shares already issued are held and must remain held by the trustees, and JLP cannot foresee creating and issuing further ordinary shares.)

5. We have considered ways of resolving this difficulty and concluded that the best way is to extend the definition of a trust to cover a trust which is able to make distributions to non-individuals, but does not in practice do so. Should the trustees of such a trust make a distribution to a non-individual (other than charitable organisations and approved profit-sharing schemes), they would once again become the associates of all the employees interested in the trust.

6. We have not discussed this solution with JLP, but we think it unlikely that they will object, as they have said that they cannot envisage any payments being made to preference (or ordinary) shareholders by the trust. We will, of course, consult them before finally going ahead with this proposal.

Other trusts

7. It is of course probable that there will be a number of trusts whose particular individual provisions will not satisfy the proposed relaxation. We do not think it is possible to devise a relaxation which will allow a wide range of (possibly unique) trusts into PRP and ESS, without unduly increasing the risk of abuse.

8. We are aware of just one other company which is unable to introduce a PRP scheme because its employees have a material interest by virtue of their association with the trustees of three benefit funds. The proposed relaxation will probably not enable them to set up a PRP scheme for all their employees; we have been unable to find any readily identifiable solution to their difficulty which would not be too susceptible to abuse.

Minor simplifying changes to the proposed relaxation

9. Following discussions with Parliamentary Counsel we have reviewed other aspects of the proposed relaxation with a view to simplifying them whenever possible. If you agree, we propose making the following changes, which relate to distributions by the trustees:

i. In our submission of 6 December we proposed that the trustees would become associates of an employee if they made a distribution to him at a time when he and/or his associates had a material interest, whether or not as a result of that distribution. The provision now contemplated is slightly less relaxed but simpler: that the trustees become an employee's associate as soon as he comes to have a material interest, whether or not the trustees have made a distribution to him.

ii. We now propose that the trustees become the associates of an employee once he and/or his associates enjoy benefits from more than the relevant percentage of shares, whatever the source of that benefit. (Previously the trustees become associates once they had made a distribution to such an employee.) Again the change has been made for the sake of simplicity.

iii. Our proposed relaxation said that where the trust also held investments other than the shares, it would be necessary to deem any distributions to have come to the maximum extent possible from the shares held in the company. We have now defined this requirement more precisely. A distribution from a trust should be deemed to have come first from any dividends declared on the shares in the company in the current financial year, then, if necessary, from such dividends declared in the previous financial year, and then, finally, from dividends declared in the financial year before the previous financial year. There is a risk that more than one employee may be deemed to have a material interest by virtue of the same dividends, but we think this risk is worth taking for the sake of simplicity.

Conclusions

10. Ministers are invited to

i. note the change we propose to resolve the difficulty JLP have identified with our proposed relaxation;

ii. note that there will of course continue to be companies and employers barred from PRP and ESS despite the substantial relaxation now proposed. One in the PRP context has been a regular complainant over the past year;

iii. note the other minor changes we propose as a result of discussions with Counsel.

We would be glad to know whether they are content.

Janice Fairfield

MS J FAIRFIELD

Robert/5/15/02/89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL
DATE: 15 February 1989

MISS HAY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Miss O'Mara
Miss Anderson
Mr Gilhooly
Mr Neilson
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

PS/IR

STARTER 112: REVIEW OF EMPLOYEE SHARE SCHEMES

The Financial Secretary was grateful for your minute of 10 February. He agrees with the Chancellor that further work should be done in the autumn with a view to a combined package next year.

R.C.M.S.

R C M SATCHWELL
Private Secretary

pmg.vd

BUDGET CONFIDENTIAL

FROM: MALCOLM BUCKLER
DATE: 15 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Tyrie

STARTER 115 - MATERIAL INTEREST

The Paymaster General has seen Ms Fairfield's submission of 14 February. He is content:

- for the Revenue to resolve the difficulty with JLP as proposed in paragraph 5 of Ms Fairfield's submission;
- (reluctantly) that there will continue to be a number of trusts whose particular individual provisions will not satisfy the proposed relaxation;
- with the minor drafting changes Revenue propose to make after discussions with Parliamentary Counsel.

MALCOLM BUCKLER
Private Secretary

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

Tdly PB/FSU

Chr/
To be aware (Mr Farmer's paper is long + boring, & no need for you to read it!).

FROM: P LEWIS
EXT: 6371
DATE: 15 FEBRUARY 1989

(FST will also need to give thought to the presentation of the ESOPs package.)

FINANCIAL SECRETARY

15/2

ESOPs (STARTER NO 113)

1. Mr Farmer's note attached seeks decisions on how an ESOP trust should be defined in the legislation; in particular who the trustees and beneficiaries should be, how the trust should operate and distribute benefits, and the time limits for so doing. You will be familiar with most of the background, and the issues, from my note of 2 February and our earlier discussions with you.

2. Mr Elliott will be sending you shortly a companion note on the tax relief itself. This will deal with how the tax relief

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Monck
Mr Odling-Smee
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Nielson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr McGivern
Mr Lewis
Mr Cleave
Mr Ridd
Mr Farmer
Mr Elliott
Mr Reed
Mr Cayley
Mr H B Thompson
Mr Fitzpatrick
Mr Creed
Mr Moule
Mr Potter
Mr M Fletcher
Mr M Swann (SVD)
Miss Brand
Mrs Majer
Mr Williams
PS/IR

would be given to the company and what would happen if the rules were broken after the corporation tax relief had been given.

3. Mr Farmer has, of course, been working closely with Mr Elliott and his colleagues in producing his suggested rules for a qualifying ESOP trust. But, as the corporation tax relief is developed, some points may come to light which suggest the need for some modifications. Given the pressure of time, however, we have thought it better to get this paper to you now, rather than wait for every interaction of that kind to be identified.

4. We said we would look to whether the definition of the ESOP trust could be simplified and shortened, now that the relief is to be confined to corporation tax. With the one exception mentioned in the next paragraph, that has not proved possible. Essentially the reason is that a fairly comprehensive set of rules is necessary if ESOPs are to complement, and not compete with, existing approved share schemes, and if your intention is still that the ESOP trustees should be required to act independently of the previous owners, with the shares being transferred unfettered into the employees' own hands on a fair basis and within a reasonable timescale.

5. The one simplification we do suggest is that the trustees should <u>not</u> be empowered to distribute some proportion of their shares to employees on a discretionary basis. This is a considerable simplification because a whole sub-set of additional rules would be necessary to cater for discretionary distributions; and it blocks off what would otherwise have been a possible avenue for abuse. Discretionary distributions do not appear to be a central feature of ESOPs. The ESOP Centre have envisaged the possibility of some discretionary distributions, but all the others we have consulted, including JOL/IOD, appear ready to see "all employee/similar terms" operate on a comprehensive basis. There are, of course, other means available - in particular the FA 1984 share option scheme - if employers wish to reward employees on a discretionary basis.

6. Even with this simplification, we estimate we shall still need perhaps 4 pages of legislation to cover the rules relating to the trust. But once these rules are in place there would be a framework available if, subsequently, you wished to consider further reliefs for ESOPs.

7. Mr Farmer needs answers to the specific questions his note raises to be able to work up instructions for Parliamentary Counsel as quickly as possible. We would be happy to discuss them with you.

Peter Lewis

P LEWIS

Inland Revenue

BUDGET CONFIDENTIAL

Personal Tax Division
Somerset House

FROM: J D FARMER
DATE: 15 February 1989

15/2

1. MR LEWIS

2. FINANCIAL SECRETARY

ESOPs (STARTER No 113)

1. It was decided at the Chancellor's meeting on 6 February that tax reliefs for ESOPs should be confined, at least this year, to a statutory CT deduction for company contributions to the ESOP trust. This paper offers suggestions as to the nature of the trust which is to qualify company distributions to it for such deductions. The matters on which decisions are now invited are set out in paragraphs 11-12.

The nature, constitution etc of the EBT

2. The essential functions of the EBT, as seen by the ESOP proponents, are

- to acquire company shares for the benefit of employees;

- to do so using finance either supplied by the company and/or in the first instance borrowed from outside lenders;

- to retain those shares at least until they have been paid for (eg by repayment of borrowing);

- to distribute shares to employees through a variety of means, and to provide a market for employees wishing to dispose of their shares.

3. Bearing those functions in mind, the Annexes to this paper look in turn at and conclude with suggestions on the various components of an EBT definition:

Annex A - who the trustees of the EBT should be

Annex B - who the beneficiaries of the EBT should be

Annex C - how the functions and obligations of the trustees should be defined (in particular, the uses to which company contributions and other income may be put; and the use of voting power conveyed by shares held)

Annex D - how shares or share interests should be distributed to beneficiaries

Annex E - the time limits on such distributions

4. The suggestions made amount to a substantial legislative commitment. In arriving at these we have of course borne carefully in mind Ministers' hopes that the EBT definition might be fairly simple and that their decision - for this year at least - to confine the ESOPs tax relief to CT deductibility would enable a shorter definition to be found adequate. But if we are to target correctly the clarified and extended CT relief in a way which delivers the policy objectives, we see little or no scope for a less comprehensive definition of a qualifying EBT than is suggested in Annexes A-E. In particular we see no alternative to spelling out the rules in some detail if the ESOP lobbies are to be given the certainty and clarification they are seeking. And a fairly full statutory definition seems to us to be essential if the legislation is to be presented as

- a new kind of employee ownership scheme likely to convey real individual employee share acquisition on a largely all-employee, similar terms basis and within a reasonable period of time;

- on conditions consistent with the existing, well-proven and successful ESS legislation;

- which will not threaten to undermine or diminish the continuing take-up and operation of approved ESS;

- which is not so open to abuse as to occasion fears either of its being brought into early disrepute or its damaging the reputation of ESS legislation generally;

- and which, if Ministers wish in future, may be built on without excessive amendment by the addition of further tax reliefs (eg for owners selling shares to the trust, or for the trustees themselves).

A statutory definition of the EBT on the lines suggested might require up to 4 pages of Finance Bill space.

Approval/registration of EBTs

5. The practical question arises of whether EBTs should have to be approved or registered by the Inland Revenue in some way before CT deductions become an entitlement. Indeed the ESOP lobbies might seek some formal Revenue approval or clearance procedure to give them the certainty they seek.

6. Nevertheless, we see clear attractions in leaving it wholly to companies with their advisers to ensure that EBTs established and operated comply with the statutory provisions, and that they can adequately show this to be the case when subsequently any question arises as to entitlement to CT deductions. Unlike the approved ESS, ESOPs/EBTs are to be assisted by an express relief for companies, not their employees, and assurance therefore of employees' favourable tax treatment is not the issue. An approval procedure might

be considered in due course, when experience has indicated whether ESOPs are a passing fashion or have real potential for providing a substantial boost to employee share ownership. In the meantime we are increasingly concerned at the burden this might represent in terms of scarce Revenue resources (and perhaps employer compliance requirements). As cases come to light, we begin to suspect that

- a variety of circumstances may soon arise in which statutory CT deductibility was recognised as available for the first time, but because of uncertainty a large number of approvals might be sought;

- a large number of existing FA 1978 scheme operators (over 800 to date) could perceive attractions in associating an approved EBT with them ie to provide early CT relief for future 1978 scheme distributions (one effect could be positively to delay share appropriations to employees under the latter). This too could therefore involve in time a heavy commitment of Revenue resources to approval work.

7. There is the further point that in some ESOP cases - particularly buy-outs - it will be imperative that the EBT is established and brought into operation very quickly. An obligation first to obtain Revenue approval for it could raise considerable and critical difficulties. For all these reasons we suggest that no approval facility be provided.

The ESOP's name

8. May we at this point invite your views on the name to be used for these arrangements? For convenience this paper sticks with Employee Share Ownership Plans (ESOPs); and, as you know, the name has already achieved fairly widespread currency as a result of the efforts of their protagonists here (eg the ESOP Centre). But this is the American name, associated with a variety of arrangements which have

attracted and continue to attract criticisms, and with a range of tax reliefs which will not be matched here. US proponents have characterised ESOPs as primarily a "financing tool" for companies; and some of them have adopted positions which seem distinctly at odds with real employee share ownership (cf the end of paragraph 12, Annex C). Arguably, therefore, the term may be both a little 'shopsoiled', and inappropriate for formal adoption here. If the Government's new initiative is not to be open to criticism by association, and is not to risk the sort of overblown reputation hitherto featuring in some UK protagonists' publicity (promoting ESOPs as the means of introducing employee share ownership in the UK - so glossing over the large strides already made by the existing approved scheme legislation (ESS)), a different title may be worth considering.

9. On present plans the legislation itself will centre on the EBT and the tax reliefs associated with it, but for all other purposes - and to avoid too close a comparison with the faster acting ESS - a possible title might be Employee Share Ownership Trust or Scheme (ESOT or ESOS) or simply Employee Share Trust (EST).

Conclusions

10. The suggestions made in Annexes A-E concerning the definition of the ESOP Trust reflect our understanding of Ministers' wishes both to set out their ESOPs proposals as an initiative which will secure individual employee share ownership and to protect the continuing success of their existing ESS legislation. They also seek to reflect the dictates of reasonably presentable legislation. For reasons of the kind indicated in paragraph 4 above we cannot recommend omitting any of the suggested components of the EBT definition.

11. We should be grateful to know, therefore, whether you approve the suggested statutory requirements of the trust as to:

- the numbers and character of the trustees (Annex A);

- the trust beneficiaries (Annex B);

- the trust's functions and obligations (Annex C);

- the trust's distributions or disposals of shares and other property (Annex D);

- the time limit within which the trust must distribute benefits to beneficiaries (Annex E). And if so, where the time limit should be set - we have suggested somewhere in the range of 5 to 10 years.

12. We invite your consideration also of:

- the suggestion that no trust approval facility should be provided (paragraphs 5 to 7);

- the name to be used for the set of arrangements of which the proposed statutory EBT will form a part (paragraphs 8-9).

J D FARMER

Encls.

ANNEX A

EBT - Trustees

1. The question is whether any particular requirements or limitations should be placed on the appointment of the trustees.

2. Mr Satchwell's note of 4 January recorded the conclusion of your 3 January meeting, that provisions might be needed to ensure the independence of the trustees. It was suggested in Mr Lewis's paper of 2 February that the majority of the trustees must be completely independent of the company and of the previous or current majority shareholders so that they properly represent the interests of the employee rather than the employer.

Background

3. The ESOPs proponents have recognised the need for control in this area: in their answer to the questionnaire the ESOP Centre suggested that a controlling or ex-controlling shareholder should not be the sole or a controlling trustee, whilst JOL/IOD concluded that substantial shareholders should not comprise the majority of the trustees. The latter went on to suggest that the trustees should comprise representatives of management, non-management employees and independent trust parties - as in the case of US ESOPs.

4. Special requirements relating to trustees apply in the following areas of tax legislation:

- Approved profit-sharing scheme trusts (FA 1978). There must be at least 2 trustees, unless the trustee is a corporate body, and one of the trustees must be resident in the UK. But, reflecting the very circumscribed powers and facilities of such trustees, no other requirements are imposed.

- Heritage maintenance funds. The trustees of trusts designed to conserve heritage property must be approved by the Revenue and must include either a trust corporation, a solicitor, an accountant, or a member of such other professional body as the Revenue may allow. The trustees, or a majority of them, must be resident in the UK and the general administration of the fund must ordinarily be carried on here.

  Applications for approval of trustees are considered on an individual basis, and a board of trustees constituted to allow the settlor to exercise control of the fund - eg where family representation or influence appears to be in the majority - would not be acceptable. There is no statutory requirement as to the number of trustees, although a minimum of 3 trustees would normally be insisted upon.

5. In the field of general charity law, the Woodfield report has recommended the application of special rules to the trustees of charities. These would entail excluding persons with a 'live' (ie not expired under the Rehabilitation of Offenders Act) criminal conviction for fraud or dishonesty, and normally requiring a minimum of 3 trustees.

ESOP Trusts

6. Three considerations point to a need for stringent requirements in relation to the trustees of ESOP trusts:

First, the trustees of profit-sharing schemes (FA 1978) are encouraged, via the provision of tax reliefs, both to acquire shares and to appropriate them to employees within short timescales (the company's CT relief is dependent on the shares being acquired by the trust within 9 months of the end of the year of account in which the deduction is claimed; and the trust's reliefs from additional rate tax and from CGT on shares held pending appropriation is conditional upon the shares being appropriated to employees within 18 months of their acquisition). ESOP trustees, however, will be able to appropriate the shares they acquire much less quickly. Consequently, there will be greater scope for diverting the benefit of the property in their care away from employees - especially the investment of trust moneys not used to buy shares. (Such misuse has been a problem in the case of small self-administered pension schemes operated by unquoted and family companies - the particular market at which ESOPs are aimed.)

Second, it is suggested in Annex C that the voting powers of the shares held in the ESOP trust should be exercised by the trustees, at their discretion. As it also likely that shares may remain in the trust for some years before distribution (Annex E) and that there should be no limit on the size of the ESOP trust shareholding, the trust could represent a formidable (including, of course, controlling) source of voting power over a considerable period. There could be occasions - eg a takeover - where the interests of the company and those of the employees conflict. In the US, there have been criticisms that some ESOPs (ie the voting powers of shares held by them) have been used as "poison pill" devices to resist takeovers and entrench existing management. Because the purpose of the employee benefit trust is to benefit employees, it seems vital to ensure that their interests are reflected in the voting of undistributed shares.

Third, if Ministers were to favour permitting a significant proportion of distributions under ESOPs to be made at the discretion of the trustees to just one or a few employees (though we have advised against this, in Annex D), the trust's discretion would be very considerable, and might be used against the interests of the generality of employees.

7. Given that the trustees of an ESOP trust may exercise considerable discretion in relation to the investment or application of the trust funds, the voting powers of the shares in the company and the timing of distributions, we suggest the following requirements:

1. Trustees must be at least 3 in number.

2. A majority of the trustees must be neither directors or ex-directors of the company or any of its subsidiaries, nor have, nor have had, a material interest in it (by material interest we mean an interest in excess of 5 per cent in the shares of the company).

3. At least half of the trustees must be employees without such an interest.

4. The trustees must include a trust corporation, or solicitor, or a member of such other professional body as the Revenue may allow.

5. All the trustees must be resident in the UK.

6. The employee trustees and the independent trustee must not be nominated, appointed or capable of removal by the company, its directors or ex-directors or any person who has or has had a material interest (5 per cent) in the company.

8. The effect of this would be that employees had to be 2 out of a total of 3 or 4 trustees. In the latter case, even where the independent (professional) trustee was, in fact,

the company's own solicitor or accountant, the employee interest would not be outnumbered.

Summary

9. We suggest the statutory definition of the trustees of the EBT should reflect the approach outlined in paragraph 7 above.

ANNEX B

EBT - beneficiaries

1. A major component of any definition of the EBT is identification of the trust's beneficiaries.

2. Precedents are essentially two:

- "Trusts for the benefit of Employees", as defined in Section 86 IHTA 1984 for the purpose of certain IHT and CGT reliefs. Such trusts must have as beneficiaries only "all or most of the persons employed by or holding office with" (for present purposes) the company, and/or relatives or dependants of those persons (and possibly, in addition to these, charities). Beneficiaries must not be appointed an interest in possession in 5 per cent or more of the trust property if the full tax reliefs are to operate.

- Trusts established under and for the purposes of an approved employee profit-sharing scheme (FA 1978). These trusts may appropriate shares only to directors or employees of the company concerned (or of a company participating in the scheme), or to those who were within the preceding 18 months such directors or employees. A 25 per cent material interest test operates on eligibility to participate.

3. Differences between these two sets of beneficiaries are clearly significant - the participation of relations of employees etc, the limited capacity for participation of ex-employees, the participation of charities, the express acknowledgment of groups of companies associated with a single trust, the different measure of material interest.

4. It is suggested that the following be reflected in the statutory definition of an ESOP EBT:

i. The beneficiaries must be all employees and directors in the company (that company being a UK resident company, and one which must not be controlled by any other company or by a consortium) the shares of which are acquired by the trust, and employees or directors in any UK resident company controlled by that company. Such people must have been employed by the company (or its group) for at least one year (but may be limited to those who have been so employed for 5 years or more) and must not include any who work less than 20 hours a week (25 hours in the case of directors).

It has not been represented to us that there may be a need for the employees etc of subsidiary companies to be included. It appears quite possible, however, that groups of companies may be among those which will be interested in introducing ESOP arrangements, and there seems no need for the narrower definition which exclusion of subsidiaries would entail. On the contrary there seems no case for permitting an approved trust to exclude employees of the latter. To do so might otherwise enable the EBT to be set up and run for the benefit of simply a relatively small number of employees in a business who were placed within the controlling company, to the exclusion of the bulk of employees in subsidiaries (the same possibility necessitates the stipulation that the company in question must not be controlled by any other or by a consortium). The further stipulation seems necessary, for tax avoidance reasons, that beneficiaries must have been employed for at least one year, and must not be part-timers working less than 20 hours a week (the 25 hour requirement for Directors mirrors the provision in the discretionary FA 1984 share option scheme legislation - but this distinction would be dropped if our Annex D suggestion on distributions is accepted).

ii. <u>Former employees or directors may be included as beneficiaries but only up to 18 months after ceasing to be employees or directors</u>.

This approach would match the existing rules for FA 1978 schemes. There is a case for excluding former employees and directors:

- few 1978 schemes do use the facility to benefit them

- exclusion might inhibit the practice here which is criticised in the US, of using ESOPs as a (relatively risky) substitute for employee pension fund or retirement benefit arrangements

- exclusion might accelerate share distributions from the EBT to serving employees

- the legislation would be a little simpler.

However we consider exclusion might be seen as unfair to those employees who retired or left shortly before a distribution could be or was made from the EBT, and the arguments for exclusion are not strong if ex-employee benefit is limited to the first 18 months after departure.

Two further considerations are relevant to this proposal. <u>First</u>, distribution through share options. A share option scheme, whether approved (FA 1980 or 1984) or not, is best regarded as conveying a benefit to an individual both when the option is granted to him and when he exercises his option. Approved schemes are set up by the company, but options could be granted under such schemes by the EBT. Unapproved schemes might be both set up and operated by the

EBT. The 18 month rule suggested above would cause no difficulties where the EBT chose to distribute through an approved all-employee FA 1980 scheme, because such options may be exercised by an ex-employee - if at all - only within 6 months of his departure. An approved discretionary scheme option (FA 1984) may however be exercised - depending on the scheme rules - at any time up to 10 years after grant, regardless of how long before exercise (but after grant) the employee departed. The proposed 18 months rule would seem not unreasonable here, however, and the same conclusion applies with regard to any unapproved option scheme introduced by the company or EBT and operated by the latter.

Second, we note that an EBT's provision of a purchase facility for ex-employee shares might technically constitute the provision of a benefit for ex-employees. If so, the legislation may need expressly to allow ex-employees access to this facility at any time.

iii. No other beneficiaries may be included.

The ESOP proponents may suggest that such a condition could be an unnecessary and unreasonable constraint, and might urge that the trust's property should be capable of use in the interests of the company's employees generally, of the local community, or of charity. The second and third of these would indeed be excluded, and there seems little real case for providing otherwise. The first would not be excluded, and so it would be possible for the trustees - subject to the constraints as to distributions suggested in Annexes D and E - to use their property (shares, voting rights, income) to the collective benefit of directors and employees. But the suggested rule would avert the risk of directors or employees standing behind companies which might otherwise be included among beneficiaries of the trust.

iv. No beneficiary may receive any part of the trust's property at a time when he has, or within the preceding 12 months had, a material interest in the company, in excess of 5 per cent (measured in accordance with the relaxed material interest test to be introduced in the 1989 Finance Bill).

Such a condition would be intended, of course, to prevent existing or recent substantial owners from benefiting from the trust's operations. To comment further:

a. it may otherwise be likely that as members of the (perhaps former) controlling family these people might often retain significant influence over the operations of the company and also - despite the suggestions in Annex A - of the trust;

b. the fairly stringent 5 per cent measure suggested which is the same as that used for IHT Trust purposes reflects the particular opportunities for abuse in the small or family company;

c. such people might already have derived benefit from the favourable tax treatment accorded to the company's payments to the trust.

Summary

5. It is suggested that an EBT definition should provide that the trust's beneficiaries must be

i. all employees or directors of the UK resident company concerned (which must not be controlled by another company or by a consortium) and its UK resident subsidiaries (if any), who have been employees or directors for 5 years or more, and who work 20 or more hours a week (25 hours in the case of directors - depending on the decision on the suggestion in Annex D);

and may also include

ii. ex-directors and ex-employees of these companies within 18 months of their departure; and directors and employees of at least one year's standing (who work the requisite hours);

but that the following must be excluded:

iii. all others;

iv. any director or employee (or ex-director or ex-employee) who at the time of a distribution or within the preceding 12 months fails a 5 per cent material interest test.

ANNEX C

EBT - Functions and Obligations

1. The broad functions of the EBT, as they appear to be seen by the ESOP proponents, are:

- the acquisition, management and distribution of shares in the company concerned,

- using contributions received from the company and (often) loan finance,

- in the interests of beneficiaries (Annex B).

Apart from the general administrative tasks which the discharge of these functions will involve, the trust will also have such detailed responsibilities as the receipt and use of other income (eg interest on cash held, dividends on shares held), meeting its expenses, managing its property, and using the voting rights attached to its shareholding. One general prohibition seems necessary to prevent a company simply cycling its money through a trust in order to obtain the tax relief. This is to prevent the trust borrowing from the company or any of its subsidiaries.

2. Generally these functions should be capable of only brief (and perhaps uncontroversial) expression as part of the statutory EBT definition. But we perceive risks of

- companies putting money into their EBTs well before it is needed or can be used for share acquisition, perhaps as a means of deferring their tax, and perhaps with no real intention or prospect of acquiring shares quickly for eventual distribution;

- EBTs using the money received to provide, in a variety of possible ways, benefits to individual directors or employees (the provision of cheap loans, or of housing or other advantages to individuals in their character as individuals or shareholders might only with great difficulty be shown to be benefits of employment and so taxable);

- conditions being put on EBT share distributions which limit in some unacceptable way the employee's subsequent freedom to enjoy his holding (eg that a payment must be made to the company's owners or former owners, or that the shares can be sold back only to them).

The time limits on EBT share distributions suggested in Annex E would not deal with these problems.

3. It appears necessary, therefore, that the otherwise general description of the functions of the statutory EBT should include particular requirements that

i. money received by the EBT should be used by a specified time (we suggest 9 months after the end of the tax year in which it was received - mirroring the FA 1978 provision) in one or more of the following ways only:

    - the acquisition of shares

    - payments of interest on borrowings

    - repayment of borrowings

    - making payments to beneficiaries (Annex D accepts the case for permitting such cash payments)

- meeting expenses;

ii. and pending such use may be retained only in cash or in bank or building society accounts;

iii. and that there must be no feature of the trust or its operations which are not "essential or reasonably incidental to the purpose of providing for employees and directors benefits in the nature of interest in shares" (a general stipulation which has been found of particular value in the administration of the approved ESS).

Shares to be acquired

4. Three general issues arise with regard to the EBT's share acquisitions, holding and distribution. The first concerns the shares to be acquired, held and distributed by the EBT. It is arguable that since the only statutory tax relief to be associated with the introduction and operation of EBTs is CT deductibility there is little need to define the securities which could be used by the trust, since such deductibility may already be an entitlement whatever the EBT acquires, (whether shares in the company or any other, whether shares or loan or preference or debenture stock) - so long as the trust is for the benefit of employees. But Ministers intend their ESOP action to contribute to employee involvement, incentive, share participation in their employing company, and these objectives would be poorly served by enabling EBTs to acquire and distribute non-equity securities in the company or securities in other - possibly wholly-unrelated - businesses.

5. The ESOP proponents themselves, including those specially concerned for employee buy-outs, have always expressed their interest as being in the trust handling ordinary shares in the company concerned - not other company securities or securities in other companies. It would be

reasonable, therefore, that the EBT should be restricted to the acquisition, holding and distribution of ordinary shares in the ESOP company (subject to paragraph 7 below).

6. We suggest that these shares be defined in broadly the same way as the shares which may be used in an approved FA 1978 scheme (the ESOP lobbies envisage, of course, that such schemes will provide the principal distribution mechanism for EBT shares). Those scheme shares are carefully defined already, of course, to ensure that what the employee gets is ordinary shares, unrestricted save in respect possibly of fair pre-emption conditions (requiring him to sell when he leaves).

7. There is one respect in which restriction of the EBT's holding to ordinary shares in the company might prove undesirable. The company may need or wish to issue other securities or rights issues to existing equity holders (eg loan or preference stock). If the trust could not take those up, the value of its own holdings could be diminished - perhaps deliberately in the interest of continuing family owners. There is another potential problem with such issues or with bonus or rights issues of ordinary shares: these might be used to avoid timing etc constraints on the EBT's distributions to beneficiaries. These problems would be resolved effectively, we think, by enabling the EBT to take up such rights or bonus issues (even where they are not ordinary shares), but requiring that they be associated with the ordinary shares which 'parented' them and that they be disposed of by the EBT as far as possible together with and certainly at the same time as the ordinary shares. This paper and these Annexes are written on this assumption.

8. A further restriction on the EBT's acquisitions seems necessary, however, relating to the price it pays. To avoid the benefit of the CT deduction being fed back to existing owners, we suggest the trust should be prohibited from

paying more than fair value, as determined by the company's auditors.

EBT retention of allocated shares

9. The second matter concerns trust distributions of shares - whether by sale or gift - direct to directors and employees, rather than through the medium of approved FA 1978 employee share schemes.

10. The choice of approach here is between allowing the trust to allocate these share to individual employee accounts, with the scrip not formally being transferred to the individuals concerned on the one hand, and, on the other, prohibiting the trust from operating in this way. The first choice would necessitate some lengthy provisions to deal both with the role of the trust making such allocations by ensuring proper taxation of employment benefits represented by them, and with the obligations of the trustees to pass on dividends and accept and act on the instruction of the employees concerned as to share disposals, action on any 'rights' issues, and the voting of the shares. Save for voting, these matters are all covered, at some length, in the regulation of the role of the special trusts associated with in the approved FA 1978 schemes.

11. The alternative choice is to deny the trustees the capacity of holding employees' shares for them in individual accounts. This seems much the better course since

- there appears to be no necessity for the EBT to hold allocated shares in the way described; and indeed it seems likely that employee perception of ownership and involvement will be keener if their shares are actually in their own hands rather than held by some grey and possibly distant trust or body of trustees;

- the statutory definition of the trust will be a good deal simpler and shorter without the provisions necessary to permit trust holding of allocated shares;

- we are not aware that the ESOP proponents set any particular store by trust retention of allocated shares. Indeed most appear to envisage distribution through an approved FA 1978 scheme (once any borrowings used to finance their acquisitions have been repaid), in order that employees can qualify for income tax relief on their acquisitions - and that involves the EBT parting with the shares (US ESOP arrangements usually have allocated shares retained in the trust's name - hence some of the criticisms that US ESOPs strengthen managements, and can be used as 'poison pills').

EBT voting powers

12. The third of the specific EBT functions which require consideration is the question of the trustees' voting power in regard to shares held in their name. The background to this is

- the absence in the approved FA 1978 scheme legislation of any requirement as to how these scheme trustees shall vote either those shares which have not yet been allocated to individual employee participants' accounts, or those which have been allocated. But in the large majority of these schemes, employers have voluntarily included rules which require the trustees to take directions from participants as to how shares already allocated to them are to be voted. This last point suggests that employers in the case of 1978 schemes recognise the importance of giving employees the full set of rights to which real share ownership should properly entitle them, and this may be why the apparent gap in the 1978 legislation about trustee voting powers has never, in our recollection, been criticised;

- the absence in the US ESOPs legislation of any requirement as to the voting of EBT shares before they are allocated to individual employees' accounts. As to the post-allocation shares still held in the trust's name, there are requirements that voting directions be sought and acted upon, on all issues, only in the case of quoted companies; in the case of non-quoted or closely-held companies such voting directions must be sought only on major corporate issues (eg merger, acquisition, sale of most of the assets).

Although on the face of it going further than the 1978 scheme statute does, this US legislation does not in practice do much to achieve or enhance employee involvement. There has over the years been considerable controversy in the US on this issue of voting rights, with the ESOP Association of America reflecting the interests of closely held company owners by actually urging the non-passage of voting rights to employees with shares allocated to them. The treatment of voting rights is one, but only one, of the factors which have given rise to serious criticisms of US ESOPs (eg their use instead of sensibly diversified employee retirement plans; their use to entrench and reinforce existing owners and management etc).

13. Ministers do not wish to see practices or abuses of the US type here (the Financial Secretary's minute of 12 December; Mr Taylor's note of the Chancellor's meeting on 13 December); but provisions as to the EBT's voting obligations or powers are not the whole answer. Statutory requirements as to the EBT's trustees and as to the EBT's share distributions (Annexes A, D and E) will go a long way to remove the occasion for criticisms and to prevent

practices inimical to real employee shareholding, involvement, participation and incentive. The requirements we suggest are all somewhat more stringent than is the case in the US.

14. If the recommendation in paragraph 10-11 above, in particular, is agreed, the result will be that the only shares which will be held at any time by the EBT in its own name will be shares which have not yet been distributed or allocated to individual employees. In consequence the only voting power available to the trustees will be in respect of the trust's own holding, ie those not yet distributed, and probably for the most part those purchased with borrowings not yet repaid. In these circumstances, and given the approach suggested in Annex A, we suggest there need be no statutory constraint as to how the trustees vote their shares.

15. This suggestion has further attractions. First, it is less likely than any other to call into question the absence hitherto of any statutory constraint on the voting powers of trustees of an approved FA 1978 scheme - paragraph 12 above. Second, it is less likely than any other to prompt proposals of the kind which we have heard made in some ESOP discussions recently, and in which co-operative circles are very interested: a requirement for a one employee/one vote system rather than one share/one vote (one employee/one vote would appear likely to represent a serious difficulty for most potential ESOP employers, quite apart from possibly making access to borrowings by the EBT a great deal more difficult). And, of course, it avoids the need for additional legislation.

Summary

16. We suggest

i. that the statutory EBT definition should content itself - as to basic functions and obligations - a broad statement on the lines indicated in paragraph 1 above, plus the stipulations suggested in paragraph 3 as to the uses to which EBT funds may be put;

ii. that the shares which may be acquired, held and distributed by the EBT be restricted broadly to those admissible as scheme shares in an approved FA 1978 scheme, and that acquisitions should be made at no more than fair value (paragraphs 4-8 above);

iii. that the EBT be prevented from retaining distributed shares in its own name (through such devices as allocation or appropriation of shares to individual employee accounts) (paragraphs 9-11 above); and

iv. that, if iii. is agreed, there is no strong case for any statutory constraint on the EBT's voting of shares which it holds (paragraphs 12-15 above).

ANNEX D

EBT - distributions to beneficiaries/disposals to others

1. This Annex examines what the definition of an EBT should contain as to limits on the kinds of property distributed to beneficiaries by the trust, the methods to be used for such distributions, and the terms on which such distributions are to be made (the identification of beneficiaries is considered in Annex B; possible time limits on distributions are considered in Annex E). It also discusses whether and how disposals of trust property to non-beneficiaries should be permitted.

2. The trust's property will essentially be either shares in the company or cash. Shares will derive from trust acquisitions whether by purchase or gift. Cash will derive from borrowings, from contributions received from the company, from dividend income from the shares held, from interest on investments and deposits, and from the proceeds of share transactions.

Property which may be distributed to beneficiaries

3. Annex B envisaged that an EBT might be permitted to use its funds in the interests of employees generally (rather than individually), and it would be consistent with this not to deny the EBT the capacity to distribute cash to employees. It appears possible that such trusts may sometimes have cash which there is no early prospect of their using to acquire further shares for distribution (eg because the controlling family will not supply - or allow the company to issue - more). Rather, therefore, than compelling such funds to be retained indefinitely in the EBT, the opportunity should be left open to it to distribute cash either direct to employees - in whose hands it would be subject to income tax - or to their collective benefit (the

alternative of the employer's own expenditure on that benefit would attract CT relief, just as the EBT's acquisition of the funds will have attracted such relief in respect of the employer's contribution to the trust).

4. This flexibility seems likely to be demanded by the ESOP lobbies. And it seems relatively unlikely to be abused if, as a result of adequately stringent time limits on share distributions (Annex E), there is pressure on the trustees to distribute shares as quickly as possible. Such pressure will mean that most available EBT funds will have to be used promptly to acquire shares or to service and repay loans taken to finance their acquisition.

Property disposals to non-beneficiaries

5. We can envisage a variety of circumstances in which the EBT may wish or need to dispose of its property to non-beneficiaries. We see no particular reason in principle to deny the trust's flexibility to dispose in this way, subject to raising any necessary charges in reflection of the fact that the property concerned was acquired using tax-relieved funds.

Distribution/disposal methods

6. Distributions of cash, if any, will naturally take the form of payments, either direct to beneficiaries as defined in Annex B, or to others (eg the employing company) to or for the benefit of such beneficiaries. If any disposals of cash were made to non-beneficiaries (eg because there were no beneficiaries left, or those who were left failed to object) recourse would be available to the CT recovery provisions proposed.

7. In the case of shares, however, the ESOP lobbies may be interested in a variety of methods of distribution:

- sale to beneficiaries, whether at market or some lower value (the latter would include the sale of shares to employees exercising options);

- gifts to beneficiaries;

- sale to non-beneficiaries (by virtue of the suggested definition of permitted beneficiaries. This should involve arm's-length transactions <u>at market value</u>. The most common form of EBT share disposal indeed seems likely to be sales <u>at market value</u> to an approved FA 1978 scheme trust - the latter, using funds contributed by the company for the purpose, would then appropriate the shares to individual employees which were income tax-free in their hands, subject to the usual '5 year retention' etc conditions).

8. It might appear unnecessary that the EBT definition should stipulate these specific methods of trust property distributions. It is evident that, as the name and prescribed function of the EBT will indicate, ESOPs will be concerned essentially and in most cases exclusively with distributions of shares to employees; and the indications are that these distributions will be made through sales (in the case of buy-outs), or through approved FA 1978 schemes which will free employees from any income tax charge on their acquisitions. It might be argued as unnecessarily restrictive to limit statutorily the methods of property distributions which the EBT might use, when the circumstances and ambitions of different companies may differ widely, and when constraints aimed at ensuring the proper operation of EBTs in line with policy objectives will take other forms (eg statutory definition of beneficiaries as in Annex B; prescriptions as to terms of distribution, below; and stipulations as to timing of distributions as in Annex E).

9. However, while leaving the trust free to distribute or dispose of its shares as best suits its own purposes and circumstances (subject to constraints on the terms and timing of distribution to beneficiaries), we consider it would be both reasonable and necessary to stipulate that trust distributions of shares to non-beneficiaries should be at open market value. This would prevent any loopholes in or dispute over the effect of trust law being used to pass benefits to non-beneficiaries, an objective to which ESOP proponents would seem unable to take any reasonable exception.

10. This general approach is consistent with the Financial Secretary's view that distributions would not have to be under an approved ESS (Mr Satchwell's minute of 4 January).

Terms of distribution

11. The timing of EBT share distributions is considered in Annex E, but an important feature of the trust definition will be the terms on which distributions to beneficiaries must be made - ie whether and if so to what extent all employees should be enabled to participate, and whether or not distributions should be on "similar terms".

12. As background to decisions here:

- US ESOPs have attracted the criticism that they have not secured wide enough participation for ESOP company employees, and that they have favoured more highly paid employees. US law has permitted a range of exclusions; and no more than a percentage (eg 70 per cent) of the remaining eligible employees need be actual participants. Some 1986 statistics suggest an average employee participation in US ESOPs of barely 70 per cent;

- ESOP proponents here were expressly asked in the Revenue questionnaire last autumn what they envisaged as to terms of distribution. The ESOP Centre suggested that at least half of the shares provided by the EBT over any 5 year period should be provided through employee share schemes that comply with the existing "similar terms" requirements for all-employee scheme participation. JOL/IOD said that where shares distributed had been acquired by the trust using tax-relieved contributions they should be distributed on an all-employee, "similar terms" basis. The Co-operative Development Agency sought distribution only to "all employees, after a nominal qualification period". The Industrial Common Ownership Finance Ltd/Industrial Common Ownership Movement felt strongly that an all-employee, "similar terms" approach should be required.

13. There seems to be no case for making any tax relief linked to statutory EBTs dependent on those trusts <u>actually distributing</u> shares to all employees. Some may not wish or be able to participate, for instance in buy-outs. The requirement in the approved all-employee share scheme legislation (FA 1978 and 1980) is that all employees must be <u>offered</u> the opportunity of participation, not that they must all accept it.

14. A view on how far EBT share distributions must be to all accepting beneficiaries must take account of a number of factors, eg

- the different views of the ESOP lobbies, noted above;

- the view (paragraph 10 above) that distributions should not have to be made through approved schemes. Only where they are made through approved schemes, therefore, and those schemes are of the FA 1978 or 1980 variety, will they necessarily end up being made on an all-employee, "similar terms" basis;

- the fact that the present interest relief for employee borrowing to acquire shares in an employee-controlled company is not conditional on all-employees of the company being given the opportunity to buy (whether on similar terms or otherwise). To the extent that ESOP EBTs were seen as facilitating employee buy-outs, therefore, a stipulation that the EBT distributions of shares which were aimed at achieving such a buy-out had to be offered on an all-employee, similar terms basis would appear to go further than has been accepted in the case of interest relief;

- the possibility that companies will wish to provide for at least some EBT distributions to be made disproportionately to senior managers, to enable such people to be retained or attracted to employment by the company. They may wish to see such distributions made through the medium of a discretionary share option scheme of the FA 1984 kind;

- the need for consistency with the existing approved employee share scheme legislation and with the wider employee share ownership objectives underlying it (with the furtherance of which the ESOP proponents express their sympathy). This points to a requirement that at least a major part of the EBT's share distributions should be offered to all-employees on similar terms.

15. There is clearly a choice to be made whether all or only a proportion - if so what proportion? - of EBT distributions should have to be made on an all-beneficiary basis and on similar terms.

16. If Ministers were minded to allow the sort of flexibility which the ESOP Centre had in mind, the approach might be

i. to require that at least 80 per cent*, say, of EBT distributions to beneficiaries, whether of shares or of cash, must be offered to all beneficiaries, and must be made to all accepting beneficiaries;

ii. to allow this condition to be met either by direct distributions to accepting beneficiaries or by distributions from the EBT which reach beneficiaries through the medium of one or both kinds of all-employee scheme approved under the FA 1978 and 1980 legislation;

iii. to require that such distributions must be made on the same similar terms basis as is currently required by the 1978 and 1980 legislation;

iv. to permit no more than 20 per cent*, say, of EBT distributions to be made to beneficiaries in any other way or on any other basis (the effect would be that this maximum would have to accommodate any 'discretionary' distributions, eg under a FA 1984 scheme, or any distributions of benefits to employees collectively, as noted in paragraph 3 above).

17. This relatively flexible approach would, however, require some complicated legislation, to deal with the risks that distributions of the discretionary 20 per cent* were made at a very early stage on a very favourable basis to the favoured few, while the all-beneficiary, 80 per cent similar terms distributions were made right at the end of the 5 or 10 year - Annex E) period allowed for distributions, on terms which were not favourable. This would be difficult. None of the existing approved schemes provide for a mixture

of discretionary and all-employee distributions. It would appear necessary to provide that any distributions in any given period (say one year) had to meet the 80 per cent requirement. To provide further, however, that they had to be on similar terms to both the discretionary and the all-beneficiary recipients might defeat the purpose of having a discretionary distribution facility at all, and it would therefore appear necessary to devise some rule prescribing a maximum disparity between the terms of the two kinds of distributions.

18. We consider that these problems point to the much simpler approach of requiring all distributions to be offered on similar terms to all beneficiaries, and to be made on these terms to all accepting beneficiaries (with the facility at paragraph 16 ii. above being made available). This approach would be entirely consistent with the underlying employee share ownership purposes of the ESOP initiative, and it would appear likely to satisfy at least most of the ESOP proponents and to be difficult for others to oppose. Discretionary distributions of shares would not be impossible, of course, but could be made (eg through FA 1984 schemes) only by the company or existing owners, not by the EBT with the assistance of CT-relieved funds.

Summary

19. We suggest

i. distributions of trust property to beneficiaries or other disposals might be in the form either of shares or cash (paragraphs 3-5 above);

ii. no requirement be made as to the method of distribution/disposal of trust property, save that any disposals to non-beneficiaries would have to be at open market value (paragraphs 6-9 above);

iii. distributions of trust property to beneficiaries should be on an all-beneficiary, similar terms basis (paragraphs 15-18 above).

*Mr Satchwell's minute of 4 January contemplated that there might be no minimum percentage requirement for share distributions made by way of approved all-employee schemes, but instead a requirement for shares to be offered on "similar terms" to all employees, together with (possibly) rules providing for minimum holding periods.

This Annex has suggested that no distributions by way of approved all-employee schemes should be compulsory, because although many ESOPs may in practice follow this route for the sake of securing income tax relief for employee participants, some - eg buy-out cases - may not, and will then contemplate either that employees buy their shares or that they pay tax on the benefit they receive. In these two last instances there seems no ground for imposing such additional requirements on employees as that they retain their shares for any particular period.

ANNEX E

EBT - Time limits on distributions

1. Ministers have always seen approved employee share schemes - to which legislation to encourage ESOPs would add a fourth type - as vehicles for providing employees with individual shareholdings, not for giving them a form of collective ownership. In these circumstances, the suggestions made in previous Annexes as to what distributions are to be made, and how, depend for their effectiveness crucially upon requirements as to when, or the time by which EBTs must distribute shares or share interests to individual beneficiaries.

2. A decision as to when shares must be distributed hangs on an evaluation of a number of conflicting considerations.

3. Arguing for <u>a long period</u>:

i. the ESOP lobbies generally seek a period of about 10 years as the maximum interval between EBT acquisition and allocation of shares. The reasons variously cited are included among the points mentioned below;

ii. in many, if not most cases, the company/EBT will wish to secure widespread and continuing employee shareholding. With normal changes taking place continually in the workforce, through employee recruitment and departures, and perhaps with expansion in the total workforce if the business thrives, this may not be easy to plan. The EBT may need, therefore, to be able to space out its share distributions over some years - especially, perhaps, if the trust acquires its shares in a large or single initial tranche, with little or no expectation of obtaining more.

Shares sold back by continuing or departing employees may come in too slowly to sustain widespread employee ownership;

iii. the EBT which relies initially on borrowings to finance its share acquisitions will usually be unable to distribute those shares until the borrowings have been repaid. Depending on the continuing or increasing prosperity of the company, and its capacity to make contributions and pay dividends to the EBT to enable the latter to service and repay those borrowings, it may be a long time - especially with high interest rates - before distributions are possible. (The 'leveraged' ESOP and the financing benefits to the company being prominent features of the US ESOP on which the lobbies here have built their case, it is curious that none of them in their replies to the Revenue questionnaire on the time limit for distribution point have urged this delaying factor. The explanation may be that - despite their reference to distribution through FA 1978 schemes - they have so far failed to appreciate that distribution of shares to employees must mean actual transfer out of the name of the trustees - not a common feature in the US);

iv. where shares are intended for use in meeting the entitlement of employees exercising share options (whether under approved schemes or not), an interval of up to 7 or more years may elapse between the grant of the option - which in the case of the private company may not take place until the shares are known to be available, eg have been acquired by the EBT - and its exercise;

v. if, as may be common, the EBT will supply shares for distribution through approved share schemes, the speed at which large distributions can be made will be subject to the individual limits associated with these schemes (up to £6,000 a year under FA 1989 proposals for the all-employee schemes). This may in some circumstances prove a constraint.

4. These are cogent arguments. Others, however, pointing to a short period of EBT ownership prior to share distribution, include

i. the approved ESS objective of securing the earliest possible acquisition by employees of shares or interests in shares. This is achieved under present legislation (a) by denying CT deductions to a company contributing to a FA 1978 scheme trust which does not acquire shares for appropriation to employees within at most 21 months of the contributions being paid (and the trust itself escapes additional rate income tax and CGT only if it appropriates the shares within 18 months of their acquisition); and (b) by ensuring, subject to limited conditions, that approved scheme share options provide the employee with rights over the shares in question (his entitlement to obtain them by option exercise at a later date) from the day he is granted his option;

ii. for so long as they remain in the EBT, undistributed to employees, shares may do little to enhance the sense of involvement and participation, and the incentives of employees. They will not, in other words, greatly serve the underlying policy purposes of the share scheme legislation. On the contrary they risk encouraging abuses of the type sometimes criticised in the US (use as a proxy for properly diversified employee retirement funds; use as 'poison pill' devices to entrench existing management etc), which Ministers wish to prevent. The suggestions as to the nature of EBT trustees in Annex A may go only a limited way to countering these threats;

iii. since the tax reliefs associated with approved employee share schemes are dependent for the most part upon employee retention for at least 5 years of the shares appropriated to him or the options granted to him, a capacity for the EBT to retain shares in its own name for as little as 3 years before distribution or option grants would mean full and tax-free individual employee enjoyment of shares distributed to him only some 8 years after the EBT acquired the shares;

iv. where the ESOP and EBT is designed to facilitate employee share purchase or even a full employee buy-out, a short time limit for distributions may cause little difficulty, since employees' purchase money will be available to the trustees to repay any borrowings, and it is likely that the shares will not stay long in the trust. Similarly where shares acquired by the trust are destined for distribution free to employees through an approved FA 1978 scheme trust, and the company has no difficulty financing the latter's acquisitions of the shares from the EBT, early repayment by the latter of any borrowings may not be difficult. Problems in complying with a relatively early share distribution obligation seem likely to be encountered by the EBT only where employees are not to pay for the shares they acquire from or through the EBT, and the company cannot pay the necessary contributions to the EBT and/or the FA 1978 scheme trust sufficiently quickly;

v. since, as confirmed in Mr Satchwell's minute of 4 January, no minimum EBT share acquisition is to be required, it may often be the case that shares can be fed into the EBT at a rate which enables onward distribution to individual employees to be arranged comfortably within a relatively short time limit;

vi. practical considerations suggest as short a time limit for distributions as possible. The only sanction for failure to observe statutory obligations, eg as to time limits on EBT share distributions, will be withdrawal or recovery in some way of the tax reliefs associated with the trust's original acquisition of the shares in question. The longer the period during which distribution can legitimately be deferred, the greater the practical difficulties are likely to be in establishing, measuring and imposing any such tax charge.

5. These conflicting considerations enable no very confident judgment to be made as to any time limit to be imposed on EBT distributions of shares. The range of choice may be between:

a. the 10 years urged by the lobbies (we would not be wholly surprised, however, if - taken at their word on this - they were then to say that longer was needed, because, for instance, they had not reckoned on mere EBT allocation to employees of shares formally retained in the trust's name not counting as distributions);

and b. a somewhat earlier date, say as little as 5 or 6 years (to provide some leeway for the repayment of EBT borrowings, and at the same time to ensure that - if distributions are made only just within this deadline - they actually reach employee participants in an FA 1978 scheme (after delays in appropriation by that scheme's trust, paragraph 4 i. above) within at least 10 years of the EBT's acquisition).

Summary

6. The choice of a precise time limit in the range between 5 and 10 years suggested above is a matter for Ministers' judgment.

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

... which points up the need for us to press DEn to decide quickly

FROM: MRS A C MAJER
DATE: 15 February 1989

1. MR PAINTER Note at end. 15.2.
2. FINANCIAL SECRETARY

EMPLOYEE SHARE OFFERS AND ELECTRICITY PRIVATISATION (STARTERS 114 AND 455)

1. You have agreed (Mr Satchwell's note of 13 February) that the draft clause for Starter 114 (technical improvements to the FA 1988 employee priority legislation) should be published by Press Release as soon as possible, since the electricity component of the legislation is unlikely to be ready in time for inclusion in the Finance Bill as published.

2. A draft Press Release is attached. We have kept this as brief as possible, as the changes were fully explained in the earlier Press Release of 11 October 1988 (copy attached) and on the assumption that Ministers will wish to minimize the risk of attracting comment in view of the probable further changes in prospect.

3. We should be grateful to know whether you are content with the draft. If so, we propose to issue the Press Release on Wednesday, 22 February.

ACMajer

MRS A C MAJER

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c Chancellor
Mr Odling-Smee
Mr Culpin
Mr Gieve
Mrs Brown
Mr Gilhooly
Mr M L Williams
Ms Hay
Mr Holgate
Mr Jenkins (OPC)

Mr Isaac
Mr Painter
Mr Bush
Mr Lewis
Mr Ridd
Mr Creed
Mr Farmer
Mr Reed
Mr Fletcher
Ms McFarlane
Mrs Majer
Mr N Williams
PS/IR

In summarising the position on tax questions, at the end of his note of 14 February on electricity privatisation, Mr Williams may inadvertently have given you the impression that almost everything is settled. That is not the case. As we have said at the last two Overviews, we cannot identify the necessary tax changes and instruct Counsel until the details of the method of sale itself are finalised, the DEn have identified potential tax problems arising from them for employee share offers, and you have decided with us what precise changes you wish to see made. We cannot make further progress on this until the flotation method is settled in detail. If that process is unduly protracted - and it is outside Revenue control - it might not be possible to have amendments ready even by Committee Stage and therefore for Finance Bill legislation this year. That would look, and be, pretty disorderly. We can only look to the Treasury to exert pressure for final decisions on the flotation method and thus give us a timetable we can meet for finalising the tax changes needed for employee share offers.

T J PAINTER

BUDGET CONFIDENTIAL

INLAND REVENUE

Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 6692 OR 6706

[3x]

February 1989

TAXATION OF EMPLOYEE PRIORITY SHARES IN A PUBLIC OFFER

Last year's Finance Act exempted from income tax the benefit which an employee may derive from being given priority rights to shares in a public offer of shares. On 11 October 1988 the Government announced some technical improvements to that legislation to be included in the Finance Bill 1989. A draft clause (attached) incorporating the Government's proposals has been published today.

NOTES FOR EDITORS

1. Two proposals were announced in a Press Release dated 11 October 1988 and will take effect from that date.

2. The present legislation exempts from income tax any benefit which may arise to employees from priority in a public offer of shares where they pay the same price for their shares as members of the public, but not where they obtain them at a discount to the public offer price. Consequently, in cases where employees obtain shares which carry both priority and discount rights, both the priority and discount benefits are taxable.

3. Under the Goverment's proposals, the priority benefit will be exempted from income tax, while the discount will remain taxable.

4. The present relief applies where no more than 10% of the total shares on offer to the public are offered in priority to employees. The 10% limit applies separately to each individual element of the total public offer. Where a public offer contains several different elements or sub-offers (eg shares offered at more than one fixed price, or a tender offer in conjunction with one or more fixed price offers) and the employees are offered shares in only one, the effect of this requirement can be to reduce the total shares which can be offered to employees in priority to well below 10% of the whole offer.

5. The second improvement proposed by the Government overcomes this difficulty by increasing the limit on employee priority to 40% of each sub-offer, but with the 10% limit for the offer as a whole remaining in place.

/Draft Clause

DRAFT CLAUSES/SCHEDULES

Priority share allocations for employees etc. [j114]

.—(1) In relation to offers made on or after 11th October 1988, section 68 of the Finance Act 1988 (which provides for the benefits derived from priority rights in share offers to be disregarded in certain circumstances) shall have effect with the following amendments.

(2) In subsection (1), the words from "at the fixed price" to "tendered" shall be omitted.

(3) After that subsection there shall be inserted—

"(1A) Where the price payable by the director or employee is less than the fixed price or the lowest price successfully tendered, subsection (1) above shall not apply to the benefit represented by the difference in price."

(4) In subsection (2), for paragraph (a) (priority shares not to exceed 10 per cent. of shares subject to the offer) there shall be substituted—

"(a) that the aggregate number of shares subject to the offer that may be allocated as mentioned in subsection (1)(b) above does not exceed the limit specified in subsection (2A) below or, as the case may be, either of the limits specified in subsection (2B) below".

(5) After subsection (2) there shall be inserted—

"(2A) Except where subsection (2B) below applies, the limit relevant for the purposes of subsection (2)(a) above is 10 per cent. of the shares subject to the offer (including the shares that may be allocated as mentioned in subsection (1)(b) above).

(2B) Where the offer is part of arrangements which include one or more other offers to the public of shares of the same class, the limits relevant for the purposes of subsection (2)(a) above are—

(a) 40 per cent. of the shares subject to the offer (including the shares that may be allocated as mentioned in subsection (1)(b) above), and

(b) 10 per cent. of all the shares of the class in question (including the shares that may be so allocated) that are subject to any of the offers forming part of the arrangements."

INLAND REVENUE
Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 6692 OR 6706

[3x] 11 October 1988

TAXATION OF EMPLOYEE PRIORITY SHARES IN A PUBLIC OFFER

Last year the Government announced that an income tax exemption would be introduced for the benefit which an employee may derive from being given priority rights - as compared with members of the public - to shares in a public offer of shares.

The Government has today announced some technical improvements to the legislation which was included in this year's Finance Act. Their effect will be that

- the exemption for the benefit from priority will be extended to apply in addition where employees are allocated priority shares at a discount to the price at which they are offered to the public (but the discount itself will remain taxable)

- where a single public offer of shares consists of several elements (eg shares offered at one or more fixed prices, by tender, or through placings) and employee priority is not given for every element in the offer it will be possible to allocate a larger number of shares to employees in priority without loss of the tax exemption.

The changes in detail

(a) Background

1. Where a company is making a public offer of shares, employees are often given priority rights, as compared with members of the public, to the shares on offer. Essentially this

/ means

these prohibitions is complex and costly, and wrote to the then Chancellor of the Duchy of Lancaster in June of this year suggesting amendments to the legislation.

5. DTI Ministers have said that the ESOP Centre's proposals will be considered, but it is unlikely that there will be an opportunity to legislate in the near future.

6. JOL/IOD regard the prospectus requirements as too demanding for employee buyouts. They suggest that offers to employees of shares in companies which are or will as a result become employee-controlled should be exempted from the normal prospectus requirements where the amount subscribed by any employee does not exceed £2,000.

7. DTI officials respond that it is premature to conclude that the requirements under the enabling powers in the FSA will be too demanding. There will be an exemption for offers to employees, in line with the proposed EC public offers directive, but the scope of this is not yet clear.

Robert/6.15.02.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL
DATE: 15 February 1989

MS FAIRFIELD - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Burr
Mr Gilhooly
Mr Ilett
Mr Tyrie
Mr Jenkins - OPC

Mr Lewis - IR
PS/IR

STARTER 115 - MATERIAL INTEREST

The Financial Secretary was grateful for your minute of 14 February. Both he and the Paymaster General are content with the conclusions in para 10.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Robert 5.16.02.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

FROM: **R C M SATCHWELL**

DATE: **16 February 1989**

MRS MAJER - IR

cc PS/Chancellor
Mr Culpin
Mr Odling-Smee
Mr Bent
Mr Gieve
Mr Gilhooly
Mr M L Williams
Miss Hay
Mr Holgate
Mr Jenkins - OPC

Mr Painter - IR
PS/IR

Might be worth following up with a letter before Parliament -

STARTER 455/114: EMPLOYEE SHARE OFFERS AND PRIVATISATION

The Financial Secretary was grateful for your minute of 15 February. He is content with the draft Press Release.

As regards Mr Painter's note about timing, the Financial Secretary has had a word with Mr Spicer and stressed the need for the Department of Energy to make quick progress on this issue.

R.C.M.S.

R C M SATCHWELL
Private Secretary

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

From: E McGIVERN
Date: 17 February 1989

[Yet another appalling submission on ESOPs]

FINANCIAL SECRETARY

ESOPs : CT RELIEF AND CLAWBACK ARRANGEMENTS : STARTER 113

1. Mr Elliott's note attached describes the nature of the CT relief to be given where a company contributes to an ESOP trust; and it seeks your agreement to the circumstances in which a clawback charge will be raised (to recover relief where the trust carries out a non-qualifying transaction or otherwise fails to meet the conditions on which relief is given to the company).

2. You will see that we are recommending that the clawback charge be raised on the trust rather than the company. There are two main reasons for this -

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cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Monck
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Nielson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins (OPC)

Chairman
Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Lewis
Mr McGivern
Mr Farmer
Mr Cayley
Mr Elliott
Mr Reed
Mr Fitzpatrick
Mr Creed
Mr M Fletcher
Mr Moule
Mr Potter
Mr Swann (SVD)
Mrs Majer
PS/IR

i. it will be the actions of the trust (or its failure to act e.g. to transfer (or sell) the shares to qualifying employees) which would give rise to the need for a recovery charge; and since the trust is required to be independent of the company - and will often have the funds from the non-qualifying transaction - it seems right in principle that it should suffer the resulting tax charge; and

ii. an important consideration, the legislation should be less complex with a charge on the trust (although we shall need to have a reserve power to go against the company or its successor e.g. if, exceptionally, the trust were without funds or realisable assets).

3. But the clawback charge will be controversial. Apart from the predictable reaction that it is another example of the scheme being hedged about with complex and off-putting anti-abuse provisions, the argument will be that it is quite unnecessary. And the comparison will be drawn with the other two methods by which tax relief - without clawback - can be obtained under existing law in respect of contributions to a trust set up to acquire shares on behalf of the employees. Neither of these methods would give the ESOP lobby the greater scope and flexibility which they are seeking. But it may be helpful to consider, briefly, both these options so that Ministers can be satisfied that the clawback charge is both necessary and defensible as part of the new arrangements.

The 1978 Employee Share Scheme

4. As Mr Elliott explains in paragraphs 6 to 9 of his note, the ESOP trust will be much more flexible than the 1978 arrangements. And the potential loss of the trust's own tax reliefs on its income and gains is by itself a powerful sanction against a trust failing to comply with the aims and conditions of the 1978 scheme.

5. So, the 1978 ESS is therefore clearly distinguishable and provides no justification for dispensing with a clawback charge as part of the arrangement for the ESOP trust.

Relief under Statute and Case Law

6. If a company could show that its contribution to an employee benefit trust was a revenue (as opposed to capital) payment laid out "wholly and exclusively for the purposes of the trade" it would be entitled to a deduction for the amount of the payment in calculating its taxable profits. And indeed the case of Heather v P-E Consulting Group Ltd confirmed the company's entitlement to tax relief in these circumstances. Briefly what happened was as follows. The senior professional staff in the company were concerned at the prospect of control being exercised by outside shareholders with no professional qualifications. And there had been past difficulties with outside shareholders. A scheme was therefore set up with the objectives of giving the staff an opportunity to purchase a stake in the company - thereby providing an incentive to greater effort on their part - and removing the possibility of outside interference. Under the trust deed, the company undertook to pay to the trustees up to 10% of its gross profits for each financial year to be applied for the purchase of its shares. The payments were to cease when the trust had acquired 40% of the share capital; and the trustees were empowered to sell the shares to employees and to make discretionary payments to them out of income from the shares.

7. The courts held that the payments by the company were revenue expenditure and that, in view of the special character of the company's business, the acquisition of the shares by the professional staff from outside shareholders was for the purposes of the company's trade.

8. Clearly these were special circumstances and inevitably, therefore, there is a fair amount of uncertainty about the

extent to which the Courts' decision is of a general application. Certainly we should have to contend that relief would not be due where an objective of the trust was to create a market in the company's shares or, in particular, to act as a vehicle for an employee buy-out. Nor could we accept that payments would be deductible where not only the company's own employees stood to benefit from the acquisition of shares but also the employees of subsidiary companies within the group. In these latter circumstances, the payments would not satisfy the test of having been incurred wholly and exclusively for the purpose of the contributing company's trade.

9. And of course it is precisely this uncertainty which has prompted the ESOP lobby to ask for clarifying (and extending) legislation.

10. In principle it is arguable that there should be a clawback charge in what I shall call these Heather trusts (if the arrangements did not in practice result in shares being made available to employees). But in practice we would seldom, if ever, be successful in the Courts. We should have to establish that the alleged purpose in making the payment to the trust was not the real purpose - in fact that the taxpayer had lied. And even where shares were acquired and accumulated in the trust - with few if any distributions to employees - experience with other cases we have taken to appeal clearly indicates that we could still not sustain a clawback charge. In an extreme case we <u>might</u> successfully contend that relief was not due to the company in respect of further contributions to the trust, but only in the most exceptional - and badly advised - cases could we ever hope to clawback <u>past</u> relief.

11. However, given the special - and we would argue limited - circumstances of the Heather case and the fact that not a great deal of use has so far been made of it, we have not seen any need to ask Ministers for amending legislation to provide a clawback charge to prevent abuse by, in effect, money box

trusts. The "wholly and exclusively" test, uncertain as it is, seems to have deterred most blatant abuse so far. So here again we believe that the absence of a clawback mechanism for these "Heather" trusts is no justification for allowing the wider CT relief to ESOP trusts without some sort of sanction to ensure that the policy objectives of the new relief are met and to guard against abuse.

12. In summary, therefore, the Government can quite properly present the clawback charge as a necessary and defensible sanction within the new and wider scheme of relief, which removes the "wholly and exclusively" test and gives certainty of CT relief. But, as we have said, it will certainly attract criticism.

Clawback Charge : The Tax Rate

13. Ministers will almost certainly be pressed to provide that the rate at which clawback is made from the trust should be the same as the rate at which relief was given to the company. But that would involve quite significant complications. The company's marginal rate could be the small companies rate of 25%, the marginal rate of 37.5% or the main CT rate of 35%. To link the clawback rate with the original relief given to the company would require detailed rules of identification and would be inappropriate, given that clawback is specifically intended to be an effective sanction against a breach of the rules. There would be little point in constructing a complex mechanism simply to ensure that, at the end of the day, the trust paid no more in tax than the company received - perhaps up to 10 years earlier - by way of tax relief.

An interest charge

14. And by the same token there ought to be an interest charge on the trust to compensate the Exchequer for the delay in receiving the proper amount of tax. But for the reasons given

by Mr Elliott, the system would be unworkable on a manual basis. So I recommend we proceed without me one but reconsider the position when BROCS is in operation, or before then if we find the new relief is being seriously abused.

Stopping relief for Heather trust arrangements

15. You may want to consider legislating to deny relief for any new Heather type trusts once the ESOPs scheme is available - in fact in parallel with the ESOPs legislation.

16. The arguments in favour are:

(i) The 1978 scheme remains available if a company wants an alternative statutory (and certain) scheme of relief for contributions to an employee benefit trust.

(ii) The Heather trusts are open to abuse; could be used as money box trusts for the well-advised company with few distributions of shares being made to employees, certainly within a reasonable period.

(iii) There is a risk that they will be used in a way which could undermine the new ESOP scheme. The trust deed might be structured on the statutory ESOP lines, but relief claimed under existing law, i.e. under the "purpose of the trade" test. If the claim succeeded and in the event shares were not being passed to employees within the specified period, we could not sustain a clawback charge unless, improbably, we could show the whole arrangements were a sham. If that claim failed relief would still be available under the new ESOP regime. So there would be certainty of relief and a possibility of no clawback. On the other hand, the "purpose of the trade" route could not be used where, for example, the contribution was a capital payment; or where (broadly) a group of companies rather than a single company was involved; or where employee buy-outs were being proposed.

(iv) The Heather trusts contribute little to the Government's objective of getting shares, unencumbered and in large numbers, into the hands of employees.

17. The arguments against are:

(i) The 1978 scheme is more narrowly based and would not give the ESOPs lobby the flexibility they are after.

(ii) The loss of the Heather route to relief would be strongly criticised by the lobbies, some of whom may well prefer it - and in particular its scope for greater influence on the trust and the absence of clawback - to what will be seen as a tightly defined and highly complex new ESOP regime.

(iii) It would be likely to increase the pressure for more generous tax reliefs for ESOP trusts;

(iv) there has so far been no significant use - and hence abuse - of the Heather trusts.

18. The choice is between having only tidy, closely targetted and detailed statutory rules for employee benefit trusts (and so cutting out Heather trusts); and avoiding an even more hostile reaction to the new ESOP regime limited to CT relief only (by leaving the Heather route open).

Cost

19. This will depend critically on take up. The existing employee share schemes have taken some time to build up. The 1978 scheme, with its wider reliefs now costs about £100 million per annum. Our judgement is that in the early years the cost will be modest and for the FSBR we should show "negligible" for 1989/90 and 1990/91 with a footnote perhaps on the lines that "the cost will depend upon take up but could amount to £20 million per annum".

20. There is the obvious difficulty here that the figures hardly suggest that the ESOP scheme will be a great success and again this will add fuel to demands for more generous tax reliefs from the outset. But it is by no means certain just what the take up will be and so the figure is very much judgemental. It seems likely however to be well short of the £100 million for the 1978 ESS.

21. We are at your disposal if you would like a discussion.

E McGIVERN

BUDGET CONFIDENTIAL

Inland Revenue

Business Tax Division
Somerset House

FROM: M J G ELLIOTT
DATE: 17 February 1989

1. Mr McGivern

2. Financial Secretary

ESOPs : CLAWBACK OF TAX RELIEF

1. Mr Farmer's paper of 15 February sets out the conditions which we recommend should have to be satisfied by an ESOP trust if contributions to the trust are to qualify for the proposed explicit statutory corporation tax relief.

2. This companion paper seeks Ministers' views on:

- the form of the tax relief itself
- whether there should be provisions for clawing back that relief in certain circumstances - and if, as we recommend, there should:
    - what should those circumstances be?
    - who should have to pay the clawback charge?
    - how should it be calculated?

The relief - general

3. The proposal is to give relief by way of a deduction, in calculating a company's taxable profits, for any payment which it makes to an ESOP trust set up for the benefit of its employees. The relief is to apply only to UK resident companies; and if contributions to an ESOP trust are to qualify, the trust must have been set up by a company not under the control of another company. But, given that an ESOP trust will benefit employees of the parent company's subsidiaries, we see no reason why a subsidiary company whose parent has established an ESOP trust should not be able to get relief for any subsequent contributions it makes to the trust, provided that the subsidiary company's employees are included among the class of qualifying beneficiaries.

4. We accordingly propose that relief should generally be available for any payment to an ESOP trust by any company whose employees are eligible to benefit under the terms of the ESOP's trust deed at the time the payment is made. I say "generally" because there is one particular set of circumstances in which we may want to refuse relief (see paragraphs 25 and 26 below).

5. Timing of relief. We think that, to match the deduction specifically available for payments by companies into 1978 employee share schemes, the relief should be available to the company for the accounting period in which the payment is made on condition that, within 9 months of the end of that period, the money paid over by the company is used for one of the ESOP's approved purposes - typically to buy shares for subsequent transmission to employees.

Clawback of relief

General

6. The first question to be considered - because it is one which we imagine will immediately be asked by the ESOP

lobbies when they see the details of these proposals - is why any clawback provision is necessary at all, given - for example - that there is no such provision in the 1978 legislation which provides for an employee benefit trust with restrictions on its powers and functions similar to those which we are contemplating for an ESOP trust?

7. The answer as we see it is this. First, an ESOP trust will be more flexible than a 1978 ESS trust. It will be able to hold on to the shares which it buys for a much longer period - and during that period the shares will belong fully to the trustees, not, as under a 1978 scheme, to the employees. (The size of the ESOP trust's holding is also likely to be larger than that of an ESS trust). Second, - and this is crucial, - a 1978 ESS trust enjoys tax relief on its income and capital gains so long as it meets the required conditions; if the conditions are not complied with, the relief is lost. An ESOP trust will not be getting any favourable tax treatment. So that sanction will not exist in the case of ESOPs.

8. There will be cases where, theoretically, an employee beneficiary of an ESOP trust could start an action for breach of trust if the trust fails to comply with the conditions suggested in Mr Farmer's note. But in practice they might well be unaware of what was going on, or unwilling to take action even if they knew.

9. It follows that, since the corporation tax relief is to be the only tax relief associated with these arrangements (at least for this year) the withdrawal of that relief is the only sanction we shall have against misdemeanours by the trustees. And, given that the relief is being given to facilitate the acquisition of shares by employees, it must be right to withdraw it if that does not happen. We therefore recommend that there should be a clawback charge.

When should the clawback charge fall?

10. As we see it, there are three sorts of action or inaction by the trust which ought to activate the clawback charge. These are:

a. Failure to distribute shares to qualifying employees within the specified time limit (5 to 10 years, as proposed in Mr Farmer's note).

b. Distributions or sales of shares to persons other than qualifying beneficiaries; or to employees on other than an "all employee/similar terms" basis.

c. Use of trust funds for other than approved purposes (approved purposes include distributions in cash to qualifying employees, payments of interest and repayments of principal on borrowings, acquisition of shares, payment of expenses).

On whom should the clawback fall?

11. Before considering how the charge should be calculated on each of these three occasions, we need to decide on whom the charge should fall.

12. The relief is to be given to the company, and so it looks right, at first blush, that it should be the company on which any clawback charge should fall.

13. But on further consideration it seems to us that there are stronger arguments for applying the clawback charge to the trust in the first instance -

a. the trustees, whose actions or inactions are to activate the charge, are to be wholly independent of the company. The company will therefore - at least in theory - not be able to determine what the trustees do or fail to do.

b. no direct benefit will necessarily enure to the company as a result of the actions at a.-c. in paragraph 10 above.

c. to make the charge apply to the company in the first instance will go towards undermining the certainty of tax relief which is one of the main points being pressed upon you by the lobbies.

14. We therefore propose that the clawback charge should fall on the trust in the first instance. But we shall have to guard against circumstances where the trust, perhaps as a result of contrived arrangements, finds itself without funds. It seems to us that we need to keep a right of recourse to the company and any successor company, in the sense of being able to assess the company rather than the trust in circumstances where it is apparent that the trust will not be able to meet the charge, and we recommend accordingly.

Rate of charge

15. We suggest that the charge should be calculated at the rate of income tax which would apply to taxable income of the trust for the year of assessment in which the event which triggers the charge occurs. At present rates that would be 25% basic rate and 10% additional rate, total 35%. This will no doubt be criticised as too high for a company liable at the small companies rate of 25%. But we do not think it would be realistic to have a variable rate.

Particular occasions of charge : amount chargeable

16. For each of the occasions set out at a. to c. of paragraph 10 above, we shall need to have rules for establishing the amount on which the charge is to fall. I take these in turn.

17. Case (a) - Failure to distribute shares to beneficiaries within specified period. In these circumstances we propose that tax should be charged on the acquisition cost to the trustees of the shares, identified where necessary on a first in first out basis. We would propose to use the relevant capital gains tax rules to arrive at the cost, for this purpose, of the shares including any which came to the trustees by way of bonus or rights issues or on a capital reconstruction of the company. We would propose to use acquisition cost even where the shares have fallen in value. This would be right in principle because the company will have had relief by reference, in effect, to the acquisition cost of the shares and the trust's capital loss will be relieved against any gains it may have; and it would be over generous to allow that relief and to reduce the recovery charge at the same time.

18. Case (b) - Sale or distribution of shares to persons other than qualifying employees: we propose that the rule here should be the same as for (a).

19. It may be suggested that there should be some form of special exemption in Case (b) to meet at least two possible sorts of circumstances, i.e.

- when, on a takeover of the company whose shares the trustees hold, the trustees (being a minority holder) are compelled to sell their shares to the successful bidder

- when trustees are obliged to sell shares to finance loans taken out because the expected contributions from the company haven't materialised. There could be other circumstances in which trustees might feel they were committed to making forced sales of this kind.

20. We recommend that we should stand firm against giving relief in any of these "forced sale" cases. The plain fact is that, for whatever reason, shares have been sold other than to qualifying employees, and there seems to be no good reason for not taking a clawback charge.

21. It may be suggested, in relation to takeovers, that - as in the USA - an ESOP could be used deliberately to frustrate a takeover, because trustees will not want to incur the clawback which will arise when they sell to the predator company. But there will be nothing, in these circumstances, to stop them distributing, or selling, shares to qualifying employees if they want to avoid clawback.

22. Case (c) - Use of trust funds for other than approved purposes. The charge would fall on the amount of the funds which were used for non-approved purposes.

Ceiling on clawback charge

23. The sort of event which will give rise to a clawback charge may occur not just in relation to funds which the trustees have had by way of tax-relieved contribution, but also in relation to other funds, e.g. which they have borrowed. It would be unconscionable to impose a clawback in relation to these other funds which have not attracted any tax relief. To meet this point we therefore propose that the amount chargeable to tax in any of the cases listed in paragraph 10 should be limited to the total amount of the corporation tax relief given up to that time on payments made to the ESOP trust, less any amount of relief taken into account on an earlier occasion of charge.

Repayment of borrowing by trustees : restriction on relief

24. We shall need to ensure that corporation tax relief is not available for payments by the company which are used to repay - or to pay interest on - loans incurred by trustees to raise money which has been used for a non-qualifying

purpose before the company's payment is made. Suppose for example that trustees borrow money from a bank (unconnected with the company which has set the trust up); use that money to buy shares; and then sell those shares to non-qualifying beneficiaries. If at that point the trustees have received no payments from the company at all, there can be no clawback charge. But if the company subsequently repays the loan from the bank, or pays interest on it, corporation tax relief should clearly not be due.

25. This looks like being a rather awkward little problem and we shall need to give further thought to it and to report back to you on a possible solution.

Double charges

26. We shall also need to ensure that there is no possibility of a double charge to tax in circumstances where trustees hold on to shares for longer than the permitted period and then sell them to non-qualifying beneficiaries.

Information powers

27. The trustees will need to keep proper records of, inter alia:-

- the contributions they receive from the company, on an annual basis
- the shares they acquire
- the shares they sell or distribute
- any other disbursements.

We shall need to include in the legislation information powers to ensure that the trustees keep the necessary records and provide the necessary information in their tax returns. We will come back to you on this when we have firmed up our views on what will be needed.

Interest

An interest charge

28. Clearly in principle there ought to be an interest charge on the trust to compensate the Exchequer for the delay in receiving the proper amount of tax on the company's profits. But the rules here would be formidably complex if we attempted to calculate a proper interest charge by trying to establish when the appropriate part of the tax due from the trust should have been paid by the company, or its subsidiaries, if the whole or part of the relief for the original contribution to the trust had never been allowed.

29. An alternative approach would be to calculate the interest back to the date the trust acquired, say, the shares which it subsequently transferred to non-qualifying employees. But again the calculations would be extremely complex; and we would need a different rule where the trust disposed of cash (perhaps part of which came from dividends on the shares or interest) to non-qualifying employees.

30. Once BROCS is up and running it should be much easier to devise and operate a proper interest charge, but for the present this approach seems out of the question.

31. A different, more rough and ready, solution might be to add a flat rate penalty type addition of say 10 per cent to the tax charge as a proxy for an interest charge. But that would be more rough than ready; and punitive where the relief to the company was at the small company's rate of 25 per cent.

32. We will give some further thought to a defensible and workable interest charge. But for the present our advice would be not to bother with one - unless we come up with a simple and defensible scheme - and look at the position again in the light of experience of the new arrangements.

Few, if any, companies are going to set up and misuse an ESOP trust simply to benefit from what at the end of the day would be delayed payment of tax, notwithstanding that it would be the trust which would suffer the clawback charge; but there is some scope for abuse here.

General anti-avoidance provision

33. As Mr Farmer has indicated in his Annex C, para 3(iii) we think it would be appropriate to borrow from the 1978 ESS legislation a provision enabling us to refuse relief if it appears that there are features of the particular arrangements (including the terms of the trust) which are neither essential nor reasonably incidental to the purpose of providing benefits for employees in the nature of interest in shares.

Repayment of clawback charge if position corrected

34. It will no doubt be suggested that if, following a clawback charge, the trustees do something which "puts matters right" - e.g. looking at a., if they eventually distribute to beneficiaries shares which they have had for longer than the required time limit - they should get back clawback tax they have paid. We think any such suggestion should be strongly resisted. The remedy is in the trustees' hands - it is up to them to act in the way required by the legislation and hence avoid the imposition of a clawback charge in the first instance.

Points for decision

35. We should be grateful to know if you agree that

- there should be a clawback charge - and if so -

- that it should fall on the trust in the first instance, with a right of recourse to the company

- that it should be charged at a rate of 35%

- that it should be charged on the occasions set out in paragraph 10 above, subject to the ceiling proposed in paragraph 23, and with provisions to avoid double charges

- that there should be no relief for forced sales of shares

- that - at any rate for the present - there should be no interest charge.

MJE

M J G ELLIOTT

 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 20 February 1989

bf. 24/2

PS/FINANCIAL SECRETARY

cc Mr Culpin
Mr Odling-Smee
Mr Bent
Mr Gieve
Mr Gilhooly
Mr M L Williams
Miss Hay
Mr Holgate
Mr Jenkins - OPC

Mr Painter - IR
Mrs Majer - IR
PS/IR

STARTER 455/114: EMPLOYEE SHARE OFFERS AND PRIVATISATION

The Chancellor has seen your note of 16 February to Mrs Majer.

2. He has suggested that it might be worth following up the timing point with a letter to Mr Parkinson. Perhaps Mr Holgate and Mrs Majer could provide a draft.

J M G TAYLOR

fim2.cr/Barker/m.020

BUDGET CONFIDENTIAL

PPS PMP

FROM: N BARKER
DATE: 20 February 1989

MW 20/2

1. MR NEILSON
2. FINANCIAL SECRETARY

cc PS/Chancellor
Mr Odling-Smee
Mr Ilett
Mr Farmer IR
Mrs Majer IR
PS/IR

ESOPS

Mr Simon Prior-Palmer, an Executive Director at Credit Suisse First Boston Ltd, wrote to you on 8 February, following his meeting with you on 2 February. He draws your attention to the Investor Protection Committee (IPC) guidelines which - other than in exceptional circumstances - prevent most PLCs from distributing more than 10% of their ordinary share capital through employee shares schemes in any 10 years. The IPCs take the view that distribution to this level is sufficient to provide incentives to employees, and that to exceed it would unfairly dilute the value of existing share holders' equity. The IPC guidelines only bite against companies that wish to create new shares for distribution. There is nothing to prevent a company that wishes to make a greater distribution from buying the shares on the open market.

2. The Revenue advise that it would not be appropriate to comment on the Burton Group scheme detailed by Mr Prior-Palmer as they are not convinced that it fully satisfies the requirements of the FA 1984 discretionary share scheme rules, and it may be the subject of continuing litigation.

3. Mr Prior-Palmer wrote to you again on 13 February, enclosing this article from "Time" magazine about ESOPs. There is nothing new in the article. But it does highlight the way in which the recent rapid growth of ESOPs and the US has been closely linked to excessive tax breaks for ESOPs, and their use as anti-takeover devices. As you know, the Revenue has attempted to avoid these dangers in drafting its ESOPs legislation. It was, however,

interesting to note that the articles suggest that employee share ownership is growing in both Japan and West Germany.

4. I attach a short draft reply, covering both letters.

Nicholas Barker

N BARKER

fi2m.cr/Barker/dl.19

DRAFT LETTER FROM THE FINANCIAL SECRETARY TO:

Simon E Prior-Palmer Esq
Executive Director
Credit Suisse First Boston Ltd
2a Great Titchfield Street
LONDON W1P 7AA

Thank you for your recent letters of 8 and 13 February about employee share ownership, which I read with interest. I am sure that you will understand when I say that I am not currently in a position to comment further.

[NORMAN LAMONT]

Robert/6.22.2.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 22 February 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins - OPC

Mr Lewis)
Mr McGivern) IR
Mr Elliott)
Mr Farmer)
PS/IR

Chx
Content with FST's conclusions?
AS 22/2

OK - Re X, I wd much prefer to use the name 'ESOPs' unless FST advises to the contrary. The drafting of this small section of the Budget speech! We will have to explain what an ESOP is. We will need to consider carefully & I shall be grateful for FST's advice.

STARTER 113: ESOPs

I have discussed the recent minutes on this with officials.

I am basically content with the Revenue's suggestions for defining the nature and activities of the qualifying trust, and for how the corporation tax relief will work. As you will see from the papers, this is not easy to draft. But I am confident we have a package here which will be reasonably attractive to those looking for certainty and clarity in this area.

I would just mention two points. On the time limit within which the trust must distribute benefits to employees, I would recommend 7 years. X I am also content to leave the name for such trusts as ESOPs. But others may have a different view.

NL.

NORMAN LAMONT

BUDGET CONFIDENTIAL

Inland Revenue

Personal Tax Division
Somerset House

FROM: N WILLIAMS
DATE: 22 February 1989

1. MR FARMER 22/2

2. FINANCIAL SECRETARY

REVIEW OF EMPLOYEE SHARE SCHEMES (STARTER 112): MARKET RESEARCH/EVALUATION PROJECT

1. You agreed (Mr Satchwell's note of 20 December) that 'market research should be commissioned to evaluate the success of the employee share scheme legislation to date'.

2. This followed the suggestion in my submission of 6 December that Ministers should agree to 'consideration of the possibility of commissioning evaluation or market research'.

3. At this stage we seek only your agreement in general terms to our plans for taking the project forward and a decision on whether Ministers would want to refer to such an exercise in the context of the Budget Speech/Budget Debates. This note has been agreed with Treasury officials (FIM and FP).

Scope and nature of the project

4. Any worthwhile survey will need to be comprehensive both in terms of the information sought and coverage

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c PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Monck
Mr Odling Smee
Mr Culpin
Mr Ilett
Mr Gilhooly
Mrs Chaplin
Mr Tyrie

Mr Painter
Mr Lewis
Mr Bush
Mr Farmer
Mr Spence
Mr Weeden
Mr Eason
Mr Fletcher
Mrs Majer
Mr N Williams
PS/IR

including, in the case of market research, information from companies that do not currently have schemes. We need to think carefully, drawing on the previous, limited, work done by others, about what questions to ask and how both companies responsible for establishing share schemes and employees participating in them can best be approached. One possible option would be to undertake a survey, conducted by an independent research company, or possibly by the OPCS such as that carried out last year for PRP.

5. Amongst other issues which will need to be resolved at an early stage are the funding of the project and whether or not it is to concentrate purely on market research as opposed to extending into the field of evaluation.

Timing of the project

6. There is much preliminary work needed before we can offer advice to Ministers on the precise shape of this project. At present, priorities must lie elsewhere, particularly on the continuing work on ESOPs, and it is difficult to envisage our being able to put much detailed work into a market research project until the Finance Bill is well-advanced in its passage through the House.

7. Given the aim of including legislation on ESOPs in the Finance Bill, a project of this kind might, in any event, provide an opportunity to gauge the potential interest in ESOPs, in addition to evaluating the success and perceptions of the existing employee share scheme legislation.

8. These considerations point to a survey being conducted, at the earliest, in the autumn this year.

Should the project be publicised?

9. Since there are already a number of measures relating to employee participation being announced on Budget Day

Ministers may consider that there is little advantage to be gained from referring also to a future market research project. At worst it might create a degree of uncertainty concerning the longer term tax treatment of the approved schemes, and so inject an unwelcome element into what is otherwise a very positive list of improvements and relaxations being announced.

10. In addition, given that the shape of the survey is still undecided, an announcement at this stage could only be in the most general terms. Questions about its precise nature could not be answered, and it would be difficult to know how to respond to requests that the results should be published.

11. The relaunch of the all-employee share schemes publicity in the autumn might, we suggest, provide an appropriate opportunity for making an announcement of a market research project, should Ministers wish to do so.

Summary

12. For the reasons given above we would recommend that, at this stage, no announcement of a future market research project should be made.

13. As soon as Budget and Finance Bill commitments permit, details of the nature, scope and timing of a survey can be worked up, in consultation with the Treasury and your approval sought for a suggested course of action later in the year. At that point, a decision could also be taken on whether any publicity for the exercise is appropriate.

14. We would be grateful, therefore, to know if you are content

i. that no announcement should be made at this stage; and

ii. that we proceed on the basis outlined above.

N. Williams

N WILLIAMS

pe1.sc/docs/share

BUDGET CONFIDENTIAL

FROM: M L WILLIAMS

DATE: 23 February 1989

FINANCIAL SECRETARY

cc. Chancellor
Mr Scholar
Mr Monck
Mr Culpin
Mr Odling-Smee
Mr Moore
Mr Bent
Mr Gieve
Mr Gilhooly
Ms Hay
Mr Holgate
Mr Jenkins (OPC)
Mr Painter (IR)
Mr D Farmer (IR)
Mrs Majer (IR)
PS/IR

Ch/
Agree with 'X' (para 5)?
23/2

OK -

EMPLOYEE SHARE OFFERS AND ELECTRICITY PRIVATISATION (STARTERS 114/455)

1. The Chancellor suggested that it might be worth following up Inland Revenue's concerns on timing with a letter to Mr Parkinson (Mr Taylor's minute of 20 February, and Mr Satchwell's of 16 February). For the reasons set out below, I would like to suggest that this is not necessary.

2. As you know, Mr Parkinson will not be writing with his proposals on the method of sale for the distcos until he has advice from Kleinwort's at the end of this month. I would then expect him to write quickly, although of course you and the Chancellor might want to take a little time before responding. I see no prospect of bringing Mr Parkinson's timetable forward, given that he has made up his mind to receive Kleinworts' paper before committing himself (or not) to the use of an Industry Share. In the meantime, however, some progress can be made on issues relating specifically to employee share offers:

(i) DEn are likely to challenge one of the decisions that you took last year when considering their proposals in the context of the now-defunct distribution share that legislative changes should not be made to enable such shares to be used in approved sharing scheme. (If an industry wide instrument were used, DEn would see advantage in being able to use this instrument in jointly owned companies approved profit sharing schemes.) Rather than wait until a decision is made on whether or not to deploy an industry share, I have suggested to DEn officials that Mr Spicer could write now on this issue, on the hypothetical basis of the Industry Share being acceptable. If the nature of this share was clear enough that would at least allow Revenue to prepare advice on this issue.

(ii) Apart from the amendment you have already agreed on the use of a consortium members DEn's share (the 3/20 to 1/20 change) which will be in the Finance Bill, DEn may wish to propose some further minor amendments, particularly in order to preserve maximum flexibility on allocation policy in the event that an Industry Share is used. Work can be done by officials to clarify more precisely the amendments that might be needed in different circumstances, when the Revenue are aware of DEn's wishes in more detail.

3. As to what other changes may be needed, however, much depends on the precise specification of the IS and how it is to be offered; and how widely shares in the individual companies are to be offered. The employee priority legislation depends wholly upon the circumstances of public offer for sale, and until the Revenue can be given clear parameters they cannot sensibly attempt to assess what changes in this legislation - which as you know is already complex and to be changed this year - may be needed (and acceptable). The Revenue heard from DEn two days ago and will be replying very shortly seeking clarification at least of these parameters.

pe1.sc/docs/share

BUDGET CONFIDENTIAL

4. The Revenue's understandable concern of course is about the undesirability of contemplating legislation to cover unknown circumstances where any provision might be both complex and seeping in order to cover a range of possibilities only one of which might materialise; and might even then fail to hit the target. I recognise that this position is not satisfactory. However I suspect that, even when a broad decision on whether or not to deploy an Industry Share is made, you and your colleagues will for wider reasons want to keep open until much nearer the sale detailed decisions on e.g. investor choices and allocation methods.

5. The Revenue's immediate difficulty is the timing and serious resource constraints.. But in the circumstances I do not recommend a letter to Mr Parkinson. You might instead like to suggest that your Private Secretary rings Mr Spicer's to make clear that you would be happy to receive - soon - a letter from him on his outstanding concerns in relation to employee share offers which could, for these purposes, assume that an IS will be used. That might at least ease one potential bottleneck. At the same time, I would ask DEn officials to do what they can, in discussion with Revenue, to narrow the range of possibilities concerning the use and characteristics of an Industry Share.

6. This note has been prepared in consultation with Inland Revenue.

M L WILLIAMS

FROM: J M G TAYLOR
DATE: 24 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Jenkins OPC

Mr Lewis IR
Mr McGivern IR
Mr Elliott IR
Mr Farmer IR
PS/IR

STARTER 113: ESOPs

The Chancellor was grateful for the Financial Secretary's note of 22 February.

2. He agrees with the Financial Secretary's proposals. He has commented that he would much prefer to use the name ESOPs unless the Financial Secretary advises to the contrary.

3. He has also commented that the drafting of this small section of the Budget speech, which will need to explain what an ESOP is, will need considerable care. He would be grateful for the Financial Secretary's advice.

J M G TAYLOR

FROM: J M G TAYLOR
DATE: 24 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Scholar
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Mr Odling-Smee
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Mr Ilett
Mr Neilson
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Mr Lewis IR
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3. He has also commented that the drafting of this small section of the Budget speech, which will need to explain what an ESOP is, will need considerable care. He would be grateful for the Financial Secretary's advice.

J M G TAYLOR

BUDGET CONFIDENTIAL

FROM: J ODLING-SMEE
DATE: 24 FEBRUARY 1989

ECONOMIC SECRETARY

cc: PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mr Peretz
Miss O'Mara
Mr Gilhooly
Miss Anderson
Miss Hay
Mr Neilson
Mr Dyer
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parly Counsel)

PS/IR)
Mr Farmer)
Mr Kuczys) I/R
Mr A Walker)
Mr N Williams)

?

SHARE OPTION SAYE SCHEMES: LETTER FROM ABBEY NATIONAL BUILDING SOCIETY

The Abbey National have suggested that they should be allowed to continue issuing share option related SAYE contracts after they convert to plc status. Mr Walker's submission sets out the issues.

2. As he says, FIM think that it would be desirable to extend share option SAYE to banks (and converted building societies). The Chancellor and the Financial Secretary have agreed to look at this for the 1990 Budget, together with the withdrawal of non-share option SAYE relief. However the Abbey National letter draws attention to a problem which we had not fully appreciated before, and which strengthens the case for action this year rather than waiting.

3. The disadvantage of waiting until 1990 is that, if the extension of share option SAYE to banks went ahead then, Abbey National and the companies which operate SAYE schemes through them would have incurred costs and disruption in shifting

new share option SAYE contracts to other building societies or DNS. They could be expected to complain, and Ministers would be in the awkward position of having to explain that there was no time to take account of their proposals in the 1989 Budget, while not admitting that consideration had been given to the possibility of extending relief to banks.

4. On the other hand, further work would be necessary on some of the details of an extension to banks. This would make the timetable tight, even if the provisions were introduced at Committee stage. Inland Revenue resources are already very stretched.

5. This is not a major issue one way or the other. But extending the share option SAYE to banks would help to level the playing field, and would avoid complaints from Abbey National (and other societies considering conversion) and companies with schemes at the Abbey.

J ODLING-SMEE

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

From: A J WALKER

Date: 24 February 1989

The Financial Secretary may be a little surprised to receive this, having just decided (15 Feb) not to act this year on SAYE. The Abbey National letter to the EST does not raise any new points: they have always known that this was part of the price of changing to plc status. It would be wrong to rush into a move now just to help them out

24/2

1. MR KUCZYS
2.) FINANCIAL SECRETARY (separate
) ECONOMIC SECRETARY copies)

SHARE OPTION SAYE SCHEMES:
LETTER FROM ABBEY NATIONAL BUILDING SOCIETY

1. This note is addressed to both Ministers because it concerns both building society conversion (EST) and a tax point concerning SAYE on which the Financial Secretary gave his view last week.

2. The Abbey National wrote to the Economic Secretary on 10 February with a copy of a letter they have sent to Sir Anthony Battishill. They are suggesting that they should be allowed to continue issuing share option-related SAYE contracts after they convert to Plc status.

---

c.c PS/Chancellor
PS/Chief Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Miss O'Mara
Mr Gilhooly
Mr Pirie
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Sir A Battishill
Mr Isaac
Mr Corlett
Mr Lewis
Mr Bush
Mr Kuczys
Mr Farmer
Mr N Williams
PS/IR
Mr Walker

AJW3 AJW95

Background

3. The clearing banks have made representations more than once in recent years that it is unfair that they, too, cannot issue SAYE contracts. Miss Hay minuted the Financial Secretary on 10 February on the issue. In the light of that, Ministers decided in principle to look at a package for 1990 which would:-

- allow the major banks (and converted building societies) to offer SAYE contracts linked to approved share option schemes; and at the same time

- withdraw non-linked SAYE from building societies.

Mr Taylor's note of 13 February and Mr Satchwell's note of 15 February record the decisions.

Point at issue

4. The letter from the Abbey National brings a new twist.

5. They have embarked on the journey to Plc status in the full knowledge that it would not be open to them to continue issuing new SAYE contracts after conversion. Ministers decided last year that the furthest they were prepared to go at that stage was to allow converted societies to continue administering contracts which had been taken out with them before conversion. A measure in last year's Finance Act made sure that they could do this. The Abbey National were told of Ministers' view in May last year, and did not pursue the matter further.

6. The Abbey are now asking for more. Given that they embarked on conversion in the knowledge of last year's legislation, the case for a change now is weak. But, if Ministers decide to extend share option SAYE to banks and converted building societies next year, there could be some

criticism (both from the Abbey themselves and the companies arranging SAYE schemes through them) if the Abbey had been prevented from issuing new contracts when they convert this Summer, only to be allowed to start issuing them again in April 1990.

Options

7. There are two alternative courses of action:-

i. bring forward the review of SAYE and introduce a measure in this year's Finance Bill; or

ii. do nothing for the Abbey National in this year's Bill, and be prepared to live with any criticism if subsequently they were allowed to issue SAYE contracts again.

We also considered the option of allowing the Abbey National to continue offering SAYE contracts on an extra-statutory basis, pending legislation next year to extend share option SAYE to banks generally. Our Solicitor tells us, however, that if we took this course of action, there would be a real possibility of judicial review proceedings.

8. The main argument against option i. is the amount of work required in a short space of time. A number of issues, mostly relating to the scope of the extension (eg whether it should apply to all banks, or a smaller group) and to the framing of the legislation, would need to be resolved. Pressures on Parliamentary Counsel and ourselves mean that there is no realistic prospect of including a measure in the Finance Bill as published. And if the measure turned out to be anything other than absolutely straightforward, we have doubts whether even a Committee Stage introduction would be feasible.

9. If option i. were adopted, a decision would be needed whether or not to withdraw non-share related SAYE from

building societies at the same time as extending share option SAYE to banks etc. We and FP do not think that withdrawing the non-share SAYE this year, particularly on the coat-tails of a provision transparently intended to help the Abbey, would be attractive; but if share option SAYE is extended to banks this year, the window of opportunity for reviewing this anachronistic relief would effectively be lost. (FIM's view, however, is that it is not necessary to combine the extension of share option SAYE with the withdrawal of non-share SAYE. They point out that there is much to be said for deferring the withdrawal of non-share SAYE, given the conjunctural situation and the possible difficulty of justifying the withdrawal of an incentive to saving).

10. The approach in option ii. is justifiable on the basis of the considerations outlined in paragraph 5 above. Those companies which offer share option schemes linked to the Abbey National would not be seriously disadvantaged, although most would be obliged to alter their arrangements and refer these to the Revenue (but the letter from GEC attached to the Abbey National's letter indicates that they already offer the alternative of DNS contracts which give exactly the same benefits. Some of the other companies on the Abbey's list are likely to be in the same position). But Ministers might have to justify an apparent change of direction next year.

Conclusion

11. Our judgement is that option ii. is nevertheless preferable: the Abbey's case is essentially weak, and their letter is not a sufficient basis on which to change Ministers' earlier decision. At this late stage in the preparation of the Finance Bill, we cannot be certain that an effective measure could be drafted in time for introduction at Committee Stage.

12. FIM's view, however, is that the option of doing nothing this year would expose the Government to unnecessary criticism in the event of a subsequent decision to extend share option

SAYE to banks in the 1990 Budget. Since the extension to banks is generally desirable for level playing field reasons, it would be better to legislate this year if possible. But they recognise the tight time constraint.

14. Whichever option is adopted, the letter from the Abbey National is best treated as a normal Budget representation. I attach a draft reply.

A J WALKER

Peter G Birch Esq
Group Chief Executive
Abbey National Building Society
Abbey House
Baker Street
London NW1 6XL

The Economic Secretary has asked me to thank you for your letter of [ ] about share option SAYE schemes.

I can assure you that your comments will be carefully considered in the run-up to the Budget. However, I hope you will understand that it would be inappropriate for me to offer further comments at this stage.

Private Secretary

AJW3 AJW95

ABBEY NATIONAL
BUILDING SOCIETY

Peter G Birch
Group Chief Executive

Abbey House
Baker Street
London NW1 6XL

Telephone: (01) 486 5555
Telex: 266103 ABBNAT G
Facsimile: Ext. 4230

9th February, 1989

Sir Anthony Battishill,
Chairman of the Board,
Inland Revenue,
Somerset House,
Strand,
London WC2R 1LB

Dear Sir Anthony,

I am writing to gain your support for a review of the conditions relating to Share Option SAYE Schemes, whereby only building societies and National Savings can offer these facilities.

As you may know, the Board of Abbey National is recommending to its members that the Society converts to public company status. If this happens then, as things stand at present, Abbey National could not take on new schemes, nor could existing schemes offer re-issues through Abbey National.

Our main concern is for the attached list of companies, whose schemes we handle at present, and their staff. Both the companies and their staff have expressed surprise and concern at the situation which appears to be facing them. There will be considerable disruption and confusion for them if secondary schemes have to be set up. The attached letter from GEC is an example of these concerns.

The Society's support for these schemes since their inception in 1980 has been whole-hearted and one we would wish to continue. At the end of January, 1989, the liability in Sharesave Schemes amounted to £139 million with over 230,000 individuals involved. It is this large number of people who are likely to find its extraordinary that Abbey National can no longer look after their savings under these schemes.

It occurs to me that since November, 1980, when this scheme was introduced, there have been major developments in the financial markets, including the changing roles of banks and building societies, which may affect your

continued....

Department's attitude towards a licensed deposit taker holding Sharesave contracts.

In view of the changing market place, can I please ask you to look at this urgently to see if anything can be done to resolve the problem.

Yours sincerely,

Peter G Birch

PETER G. BIRCH
Group Chief Executive

9th February, 1989

c.c. Mr. Peter Lilley

COMPANY SCHEMES

COMPANY NAME

ALFRED BOOTH PLC
AMERICAN EXPRESS
ARGYLL GROUP PLC
AUTOMATED SECURITY HOLDING
BRITISH AIRPORTS AUTHORITY
BRITISH ALUMINIUM CORP
BRITISH AEROSPACE
BARBOUR INDEX LTD
BRITISH AIRWAYS PLC
BRENT CHEMICALS
BEJAMS
BAIRSTOW EVES
BEAZAR
BRITISH HOME STORES LTD
BIBBYS
BIOMET LTD
BRAHAM MILLAR GROUP PLC
BOC INTERNATIONAL LTD
BOWATER INDUSTRIES PLC
BOOTS
BOWTHORPE
BRITISH PLASTER BOARD IND
BRITISH PETROLEUM
BRYANT HOMES
CLYDE PETROLEUM PLC
COALITE GROUP PLC
COMET INDUSTRIES
COSTAIN
COURTAULDS PLC
CAPARO INDUSTRIES LTD
COMMERCIAL UNION ASSUR PLC
CUNDELL GROUP PLC
DALE ELECTRIC INTERNATIONAL PLC
DEBEHAMS
DATA RESEARCH SERVICES
DUBILIER PLC
EATON LTD
EDGLEY AIRCRAFT LTD
EUROPEAN FERRIES GROUP
ELECTROCOMPONANTS
ELSWICK PLC
ENTERPRISE OIL
ERSKINE HOUSE PLC
EXPAMET INTERNATIONAL PLC
EXTEL
FERGUSON IND HOLDINGS
FINLAY PACKAGING PLC
FISONS
ROBERT FLEMING
FLIGHT REFUELING HOLDINGS
FOSTER BROTHERS
FRENCH KIER

COMPANY NAME

GENERAL ELECTRIC COMPANY
GEI INTERNATIONAL LTD
GIROFLEX LTD
GOOD RELATIONS
GREENFIELD LEISURE
HAYDEN PLC
HAMPSON PLC
HARDING GROUP
HILL AND SMITH PLC
HOW GROUP PLC
HUNTER SAPHIR PLC
IMPERIAL CHEMICAL INDUSTRIES
INTERNATIONAL COMPUTERS
IMPERIAL METAL INDUSTRIES
IMTEC MICROFILM LTD
INTER EUROPE
J JARVIS & SONS
JAMES BEATTIE PLC
JAMES FISHER & SONS
JOHNSON GROUP CLEANERS LTD
KENNING MOTOR GROUP
JOHN LAING & SON
LAZARD BROTHERS
LLOYDS BANK
LONDON MERCHANT SECURITIES
LUCAS INDUSTRIES
MATTHEW HALL PLC
MANSELL
MARTINS NEWSAGENTS
MARKS & SPENCER
MEGGIT HOLDINGS PLC
METALRAX
MICROGEN HOLDINGS PLC
MIDLAND BANK
MICRO FOCUS
MITCHELL SOMERS PLC
MOORGATE MERCANTILE HOLDINGS
3M UK PLC
MOSS BROSS
JOHN MOWLEM LTD
NORTHERN FOODS LTD
NORDIC BANK PLC
NEIL & SPENCER HOLDINGS
NURDIN & PEACOCK
NATIONAL WESTMINSTER BANK
OCTOPUS PUBLISHING GROUP
PEARSON & SON
PERICOM
PLASMEC PLC
PLESSEY
PORTALS LTD

COMPANY NAME

RAINE INDUSTRIES PLC
RANK ORGANISATION
REED INTERNATIONAL PLC
RENOLD PLC
RANSOME HOFFMAN POLLARD LTD
ROLLS ROYCE
SAATCHI & SAATCHI
SAGA HOLIDAYS
SAVAGE INDUSTRIES
SECOMBE MARSHALL & CAMPION
SEDGWICK
SINCLAIR GOLDSMITH HOLDING
SIMON ENGINEERING
SCOTTISH & NEWCASTLE BREWE
STODDARD HOLDINGS
STEWART WRIGHTSON HOLDINGS
TARMAC
TESCO
TELEPHONE RENTALS
TIPHOOK PLC
TATE & LYLE
W & J TOD PLC
TRICENTROL
TUBE INVESTMENTS
TAYLOR WOODROW
TYZACK
TURNER PLC
UNITED ELECTRONIC HOLDINGS
UEI PLC
UNITECH PLC
VALOR GAS
VETERINARY DRUG CO PLC
VICTAULIC
VIKING PACKAGING GROUP
VOLEX GROUP PLC
WATTS BLAKE BEARNE
WILSON CONNELLY HOLDINGS
WILLIAM COLLINS
WELLCOME PLC
WHITECROFT PLC
WARNER HOWARD GROUP
WAGON INDUSTRIAL HOLDINGS
WIMPY
WOLSTENHOLME RINK LTD
WARD WHITE
Y.J LOVELL

THE GENERAL ELECTRIC COMPANY, p.l.c.

1 Stanhope Gate · London W1A 1EH

TELEX 22451 · Cables: Polyphase London W.1 · Telephone: 01-493 8484

SEC/JHC/RG

7th February, 1989

Peter Birch Esq
Chief Execuitve
Abbey National Building Society
Abbey House
Baker Street
London NW1 6XL

Dear Mr Birch

<u>GEC Employee Savings-Related Share Option Scheme</u>
<u>("Savings-Related Scheme.")</u>

I was disappointed to learn from Mr Ellis's letter to Mrs Morrison that it seems that we will not be able to use Abbey National for future offers under our Savings-Related Scheme if Abbey National becomes a Public Limited Company as proposed.

I was particularly disappointed to learn of this effectively through the initiative of a competitor(!), since I would have assumed that our close relationship involving five major offers over the last six or seven years would have enabled you to keep us informed at an early stage.

More important, however, is the considerable inconvenience which we, together with other companies in our position, will suffer as a result of having either to select another Building Society or, alternatively, to withdraw the Building Society choice from our employees. If another Building Society is selected for future offers, certain areas of our administration will be duplicated with the existing savings contracts over the next four years; we still cannot be certain that any new Building Society selected will not itself become incorporated and thus disqualified as a savings medium for further offers.

For our part we have been well satisfied with our relationship with the Abbey National since 1982, and would not wish at this stage either to change or to drop Building Societies generally as a choice of savings medium; the fact that some 75 per cent of our employees' current savings contracts (15,500 contracts of some 11,300 employees) are with the Abbey National, (the remaining 25 per cent being with the Department for National Savings) is evidence that our employees share that view.

Continued ....

In general we are at a loss to understand what actual difference, other than a technical one, the incorporation of Abbey National makes to the conditions for approved savings contracts under savings-related option schemes. I hope that those of our employees who have existing Abbey National contracts will not attribute their being prevented from taking out further contracts with Abbey National to any official fears concerning the security of their savings, especially since existing contracts will not be transferable to any new Society. This could be of considerable embarrassment to us. Is there any chance that the relevant authorities will rethink this whole situation in the light of the changed, and changing, rules governing such matters?

We have in the past made annual offers in January, although as you know we had to forego an offer this January due to our bid for The Plessey Company; it is possible therefore that we would wish to make an offer following publication of our final results in July. We will now be giving urgent consideration as to whether we should continue to offer another Building Society for employees' savings, and if so the Society to be selected.

Yours sincerely

John Chaplin.

J H Chaplin
SECRETARY.

chex.rm/jmt1/59 **BUDGET CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 24 February 1989

PS/FINANCIAL SECRETARY

cc Mr Scholar
Mr Monck
Mr Culpin
Mr Odling-Smee
Mr D J L Moore
Mr Bent
Mr Gieve
Mr Gilhooly
Ms Hay
Mr Holgate

Mr Jenkins - OPC
Mr Painter - IR
Mr D Farmer - IR
Mrs Majer - IR
PS/IR

EMPLOYEE SHARE OFFERS AND ELECTRICITY PRIVATISATION (STARTERS 114/455)

The Chancellor has seen Mr M L Williams' note of 23 February.

2. He is content not to write to Mr Parkinson at this stage. He is also content for you to telephone Mr Spicer's office to make clear that the Financial Secretary would be happy to receive a letter from Mr Spicer on his outstanding concerns in relation to employee share offers which could, for these purposes, assume that an IS will be used.

J M G TAYLOR

fim2.cd/barker/min19

BUDGET CONFIDENTIAL

FROM: N BARKER
DATE: 27 FEBRUARY 1989

1. MR NEILSON
2. FINANCIAL SECRETARY

We have not told DTI about the Budget package, and see no need for them to know before the Budget, since they will not be tabling amendments until April. If anything happens to change this assessment, we will come back to you. A reference to the Companies Act change might be worth including in the Budget speech.

MN
1/3

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Monck
Mr Odling-Smee
Mr Culpin
Mr Burgner
Mr Ilett
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Painter IR
Mr Lewis IR
Mr Farmer IR
PS/IR

ESOPs

Mr Neilson's minute of 9 December identified three non-tax difficulties that have been raised by the ESOPs lobbies. DTI has responsibility for the relevant legislation (Companies Act, and Financial Services Act), and you agreed that we should discuss these questions with DTI officials. This minute reports the outcome of these discussions.

Companies Act

2. Financial assistance by a company for acquisition of its own shares is generally prohibited (s 151) but an exception is made for employee share schemes (s 153(4)). At present that exception is limited to:

i. The provision by the company, in accordance with an employee share scheme, <u>of money</u> for the acquisition of fully paid shares in the company or its holding company;

ii. The making by a company <u>of loans to employees</u> for the same purpose.

3. As the Act stands it would prevent a PLC from <u>providing a guarantee</u> for an ESOP's external borrowings. The ESOPs lobbies have suggested that, in practice, most banks would be prepared to lend to an ESOP <u>only</u> on the security of the parent company's guarantee. The precise wording of this Section goes back to 1928, and appears to be intended to prevent share manipulation during a take over bid.

4. Earlier this week, in response to an amendment moved by Lord Lloyd, Lord Strathclyde said that the Government would consider, as a matter of the highest priority, an appropriate amendment for inclusion in the Companies Bill. (ORHL 21 February 1989 Col 541 to 548 attached). Our subsequent contacts with DTI suggest that they hope to table a suitable amendment by Lords third reading in mid-April, provided they can establish suitable safeguards against misuse of ESOPs in a takeover situation.

<u>**Financial Services Act**</u>

5. There are two questions here:

i. Certain types of ESOP may fall within the Act's definition of a "collective investment scheme", requiring authorisation of trustees;

ii. The lobbies have asked for confirmation that an ESOP would be exempt from the Act's prospectus requirements.

6. DTI officials have assured us that either of these provisions in the Act poses genuine difficulty for an ESOP. On the first they argue that an ESOP is unlikely to be caught because it will not involve either "pooling" of money nor "collective management", the two tests of a collective investment scheme. If an ESOP is caught, the only result would be that any outside trustee would have to be an authorised person under the FS Act. DTI argue that this would not be too onerous. On the second question, DTI cannot

envisage any situation in which an ESOP would not benefit from the existing exemption for offers of shares to employees.

Conclusion

7. The key difficulty is with the Companies Act, and DTI seem willing to make the necessary changes in this year's Companies Bill. The problems raised by the ESOP lobbies about the Financial Services Act do not seem well-founded. We do not think you need write to Lord Young to put pressure on him to make changes. But it might be worth referring to the Companies Act change in the Budget Statement, in which case you will want to clear this with Lord Young; we can provide a draft letter.

pp E. Hickman

N BARKER

Robert/2.28.2.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 28 February 1989

PS/CHANCELLOR

cc
Mr Monck
Mr Scholar
Mr Culpin
Mr Moore
Mr Odling-Smee
Mr Bent
Mr Gieve
Mr Gilhooly
Mr M L Williams
Miss Hay
Mr Holgate
Mr Jenkins - OPC

Mr Painter)
Mr Farmer) IR
Mrs Majer)
PS/IR

STARTERS 114/455: EMPLOYEE SHARE OFFERS AND ELECTRICITY PRIVATISATION

Following Mr Williams' minute of 23 February, I have spoken to Mr Spicer's office to let him know that the Financial Secretary would be happy to receive a letter setting out his concerns about the employee share offers, and which assumed (for these purposes) that an Industry Share will be used.

This should arrive shortly. When it does, the Revenue will be able to give early advice on the two main areas of difficulty:

- whether the Industry Share is admissible as a "scheme share" for the purposes of the FA78 all-employee profit-sharing legislation;

- whether the Industry Share arrangements constitute an "offer to the public" so that employees may benefit from the tax relief for priority share allocations under S.68 of FA88 (as amended this year).

The Revenue will also provide advice on whether any legislative changes should be in this year's Finance Bill or next.

R.C.M.S.

R C M SATCHWELL
Private Secretary

est.ld/james/28 Feb/FST

BUDGET CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 28 February 1989

PS/FINANCIAL SECRETARY

cc: PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mr Peretz
Miss O'Mara
Mr Gilhooly
Mr Pirie
Mr Dyer
Miss Hay
Mr Neilson
Miss Anderson
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parly Counsel)

PS/IR
Mr Farmer - IR
Mr Kuczys - IR
Mr A Walker - IR
Mr N Williams - IR

SHARE OPTION SAYE SCHEMES : LETTER FROM ABBEY NATIONAL BUILDING SOCIETY

The Economic Secretary has seen Mr Odling-Smee's minute of 24 February and Mr Walker's note of the same date.

2. He has commented that if we announced this year our intention to extend SAYE share options to Banks next year and let the Abbey continue theirs until then under an ESC, he cannot imagine anyone would initiate a judicial review.

S M A JAMES
PRIVATE SECRETARY

Robert 03.2.03.89 BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 2 March 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Miss O'Mara
Mr Pirie
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Farmer)
Mr Kuczys) IR
Mr Walker)
Mr N Williams)
PS/IR

Ch: Agree FST?
2/3

Agree

SAYE SCHEMES: LETTER FROM ABBEY NATIONAL

It seems to me there is an overwhelming case for extending share option SAYE schemes to banks (and converted building societies). Indeed, I can't for the life of me see why they were excluded in the first place. However, it's rather late in the day for Abbey to ask "to see if anything can be done" in this year's Budget, particularly when they knew the current position as long ago as last May. Given the pressures on Parliamentary Counsel, I don't favour legislation this year.

That leaves the question of what, if anything, we should do for Abbey in the period between their conversion this Summer, and the introduction of any measures we may include in the 1990 Finance Bill. There is the possibility of an ESC. However, that would put the Board (whose concession it would be) in an awkward legal position, and I would not recommend it. I can see the Economic Secretary's point that if we announced beforehand our intention to

hide behind

extend the new treatment to banks, it is unlikely that any of them would seek to initiate a judicial review. But it would nonetheless be inequitable.

On balance therefore I recommend doing nothing for Abbey this year, and sticking to your original suggestion of a combined package (including abolition of the non-share option SAYE relief) next year. There might be some criticism from Abbey, despite their slowness in getting their own act together. But it will not affect existing contracts, so I doubt it would be severe.

NL

NORMAN LAMONT

chex.ps/jmt
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BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 3 March 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Miss O'Mara
Mr Pickford
Miss Hay
Mrs Chaplin
Mr Tyrie
Mr Jenkins - OPC

Mr Farmer - IR
Mr Kuczys - IR
Mr Walker - IR
Mr N Williams - IR

SAYE SCHEME: LETTER FROM ABBEY NATIONAL

The Chancellor has seen the Financial Secretary's note of 2 March. He agrees that we should do nothing for Abbey this year, and that we should stick to the original suggestion of a combined package (including abolition of the non-share option SAYE relief) next year.

J M G TAYLOR

FROM: J M G TAYLOR
DATE: 3 March 1989

PS/FINANCIAL SECRETARY

cc Mr Monck
Mr Scholar
Mr Culpin
Mr Monck
Mr Odling-Smee
Mr Bent
Mr Gieve
Mr Gilhooly
Mr M L Williams
Mr R Satchwell
Miss Hay
Mr Holgate
Mr Jenkins - OPC

Mr Painter - IR
Mr Farmer - IR
Mrs Majer - IR
PS/IR

STARTERS 114/455: EMPLOYEE SHARE OFFERS AND ELECTRICITY PRIVATISATION

The Chancellor has seen your note of 28 February. He has commented: "Good".

J M G TAYLOR

Robert 03.3.03.89 **BUDGET CONFIDENTIAL**

FINANCIAL SECRETARY TO THE TREASURY

Pmp

FROM: **R C M SATCHWELL**

DATE: **3 March 1989**

MR BARKER

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Painter)
Mr Lewis) IR
Mr Farmer)
PS/IR

ESOPs

The Financial Secretary was grateful for your minute of 27 February. He agrees that there is no need to write to Lord Young about the Financial Services Act points. He also agrees that the Companies Act change is worth putting in the Budget Statement; I should be grateful for a draft letter to Lord Young.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

Personal Tax Division
Somerset House

FROM: MS J FAIRFIELD
3 MARCH 1989

1. MR LEWIS
2. FINANCIAL SECRETARY
   PAYMASTER GENERAL

It looks as though we are near to devising a workable solution to this complex problem. But even with the simplifications Ms Fairfield envisages here, the legislation will be considerably longer than the original estimate (para 9). This illustrates how extraordinarily difficult it is to estimate the length of legislation in advance of detailed solutions and instructions to Counsel enabling him to see how he needs to tackle the drafting.

3/3

STARTER 115 - MATERIAL INTEREST

1. You will recall from both my original Starter submission of 6 December and from my progress report of 14 February that a number of complex issues were involved in the relaxation of the material interest tests (which would make employees' participation in a registered PRP scheme or an approved employee share scheme easier; and which would correspondingly adjust the test of eligibility for close company interest relief).

2. The changes involved affect four different sets of legislation (ESOPs as well as the three mentioned above), and the approach agreed breaks new ground (the measurement

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cc PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Burr
Mr Gilhooly
Mr Ilett
Mr Tyrie
Mr Jenkins (OPC)
Mr Painter
Mr Lewis
Mr Bush
Mr Creed
Mr O'Connor
Mr Farmer
Mr Brannigan
Mr O'Hare
Mr Fletcher
Mr Pardoe
Mr Orhnial
Mrs Majer
Ms Fairfield
Mr Annys
PS/IR

of an employee's interest to depend on what he actually receives from the trust and not - as hitherto - the simple but more arbitrary measure of what he could receive from it).

3. My 14 February note reported the latest developments, and the adjustments we proposed to make to the detailed legislative approach. You were content with them. This note further updates the position in the light of continuing discussions with Counsel (and informal contacts with the John Lewis Partnership) and receipt of the first part of his draft provisions.

4. Paragraphs 3 to 6 of my 14 February note gave details of the solution we proposed to resolve a particular difficulty which the John Lewis Partnership had identified with the proposed changes. We have now checked that they are content with the solution we suggested.

5. Further discussions with Parliamentary Counsel have led us to make two changes for the sake of simplicity.

6. The first is that the relaxation should apply to trusts which make distributions only in the form of ordinary shares in the company or money, even though they may be empowered to make distributions in other forms. This avoids the need to include in the Finance Bill difficult and complicated provisions for calculating the cash value of other forms of distributions eg cheap loans. Distributions in this form are, we think, likely to be relatively rare.

7. Secondly, we have reviewed the method of relating cash distributions by trustees to an equivalent shareholding. This can be a complex problem, especially where the trust holds other assets in addition to ordinary shares of the company. The method outlined in paragraph 9iii. of my 14 February note would have been viable, though to cater for the variety of situations that can arise - eg changes in the trust's holdings, changes in the company's issued capital -

it was recognised on detailed consideration that the precise provisions required would be particularly complex. We have now devised an alternative approach, which converts a cash distribution to an employee into the equivalent of a percentage of the company's ordinary share capital using a mathematical formula. Broadly speaking, this calculates the maximum of an employee's cash receipts (over the past 12 months) from the trust which could have been derived from the trust's shareholding in the employing company (taking into account income received by the trust over the last 3 years in respect of shares) as a percentage of the average annual distributions (over the same 3 years) made by the company in respect of all its shares.

8. This formula produces the result we want to achieve, and should be easier for companies both to understand and to operate.

9. In our submission of 6 December we estimated that the material interest changes would require one page of Finance Bill space. The changes have turned out to be considerably more complex and detailed than originally envisaged. They have now to accommodate ESOPs as well, and the close company interest relief item has to remedy untidynesses deriving from the ICTA consolidation. On the basis of a first draft of one of the parts of the provision (that for PRP), the whole package for all four parts of legislation could require as much as 10 pages. We are now exploring with Counsel whether an alternative approach to the drafting would enable the requirement to be kept down to perhaps no more than 5 or so pages in all.

10. Ministers are invited to note

i. the John Lewis Partnership are now content with the proposed relaxation (although they have not yet seen the draft provisions). We propose renewing our contact with them to make sure all is well; and

ii. the further adjustments of approach now being pursued with Counsel, together with our endeavours to keep the size of the resulting provisions down to as few pages of Finance Bill space as possible.

We would be glad to know whether they are content.

Janice Fairfield

MS J FAIRFIELD

Susan 09.6.03.89 BUDGET CONFIDENTIAL

FROM: MISS S J FEEST

DATE: 6 March 1989

MALCOLM BUCKLER

PS/PAYMASTER GENERAL

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mr Burgner
Mr Culpin
Mr Burr
Mr Gilhooly
Mr Ilett
Mr Tyrie
Mr Jenkins (OPC)
Ms J Fairfield - IR
Mr P Lewis - IR
PS/IR

STARTER 115 - MATERIAL INTEREST

The Financial Secretary has seen Ms Fairfields's minute of 3 March 1989 and is content with the proposals made.

Susan

SUSAN FEEST

fim2.cr/Barker/m.027

COVERING
BUDGET CONFIDENTIAL

FROM: N BARKER
DATE: 7 March 1989

MW 7/3

1. MR NEILSON
2. PS/FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Painter)
Mr Lewis) IR
Mr Farmer)
PS/IR

ESOPs

I attach a draft letter for the Financial Secretary to send to Lord Young about the Companies Bill question. This has been cleared with the Revenue.

Nicholas Barker

N BARKER

DRAFT LETTER FROM THE FINANCIAL SECRETARY TO LORD YOUNG

EMPLOYEE SHARE OWNERSHIP PLANS (ESOPs)

Nigel Lawson intends announcing in the Budget a number of tax changes to facilitate ESOPs. I understand that you have separately been considering a non-tax difficulty within your field of responsibility, and that you plan to bring forward legislation to deal with this at a later stage of the Companies Bill. It would be helpful to make clear, when the tax changes are announced, that action is being taken to remove this unnecessary legal barrier to the development of ESOPs. Indeed Nigel would probably wish to refer to it in his Budget Statement, if that is acceptable to you.

Our view is that ESOPs can have a valuable role in encouraging employee share ownership where the current tax reliefs for employee share schemes are not enough. Two particular areas are employee buyouts, where the amount of shares passing to employees is too large to be accommodated through existing schemes, and private companies, whom the current share schemes have had only limited success. The main concern expressed by the ESOPs lobbies is to ensure that a company's payment to its ESOP should be deductible for corporation tax purposes. We propose to provide this certainty by legislating for a specific CT relief for a company's contribution to a statutarily defined employee benefit trust which operates in accordance with set conditions. The conditions will be designed to ensure that the trust provides genuine individual employee share ownership.

Section 151 of the Companies Act prohibits a company from providing financial assistance for acquisition of its own shares, except for employee share schemes. However, that exception (Section 153) is limited to provision by the company of money via an employee share scheme, for the acquisition of fully paid shares in the company or its holding company, <u>or</u> the making via the company of loans to employees for the same purpose. ESOPs proponents have suggested that it should be possible for a company to provide ESOPs with general financial assistance, rather than the more narrowly defined "money." In particular, it has been suggested that a company should be able to provide a <u>guarantee</u> for an ESOP's external borrowings on the grounds that a bank would generally be prepared to lend to an ESOP only on the security of the parent company's guarantee. There is also some doubt whether a company may make payments to such a trust in order for it to pay interest on and repay such borrowings. An extension of the exception to cover "financial assistance" would also remove this doubt.

I was interested to see the recent debate on the Companies Bill (ORHL 21 February 1989 Col 541-548), in which Lord Strathclyde said that the Government would consider bringing forward such an amendment in the Companies Bill as a matter of priority. I believe that such an amendment, with appropriate safeguards to prevent abuse, would be highly desirable.

Are you happy with this analysis, and with our proposal that the intention to include ESOPs legislation in the Companies Bill should be referred to in the Budget speech? If so, perhaps our officials could agree urgently a short reference that might be included.

[NORMAN LAMONT]

Robert 05.8.03.89 **BUDGET CONFIDENTIAL**

PMP

cc: PPS, CST, PMG, EST
Sir P. Middleton
Sir T. Burns
Mr. Monck
Mr. Scholar
Mr. Burgner
Mr. Culpin
Mr. Odling-Smee
Mr. Gilhooly
Mr. Ilett
Mr. Neilson
Mr. N. Barker
Mrs. Chaplin
Mr. Tyrie
Mr. Call
Mr. Painter IR
Mr. Lewis IR
Mr. Farmer IR
PS/IR

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
London
SW1H QET

8th March 1989

Dear David

EMPLOYEE SHARE OWNERSHIP PLANS (ESOPs)

Nigel Lawson intends announcing in the Budget a new tax relief to encourage the spread of ESOPs. Our view is that ESOPs can have a valuable role in encouraging employee share ownership in certain situations where the current tax reliefs for employee share schemes are not enough. Two particular areas are employee buyouts, where the amount of shares passing to employees is too large to be accommodated through existing schemes; and private companies, where the current share schemes have had only limited success. However, the ESOPs lobbies have pointed out that a company's payments to its ESOP are not always deductible for corporation tax purposes under existing tax law; and have said that this uncertainty is the major barrier to the development of ESOPs in the U.K. We therefore propose to provide certainty in this area by legislating for a <u>specific</u> CT relief for a company's contribution to a statutorily defined employee benefit trust which operates in accordance with set conditions. The conditions will be designed to ensure that the trust provides genuine individual employee share ownership.

This tax change should be of considerable benefit to companies wishing to set up an ESOP, and will be widely welcomed by the ESOPs lobbies. However, I understand that you have separately been considering a non-tax difficulty within your field of responsibility.

Section 151 of the Companies Act prohibits a company from providing financial assistance for the acquisition of its own shares, except for employee share schemes. However, that exception (Section 153) is limited to provision by the company of money via an employee share scheme, for the acquisition of fully paid shares in the company or its holding company, <u>or</u> the making via the company of loans to employees for the same purpose. ESOPs proponents have suggested that it should be possible for a company to provide ESOPs with general financial assistance, rather than the more narrowly defined "money." In particular, it has been suggested that a company should be able to provide a <u>guarantee</u> for an ESOP's external borrowings on the grounds that a bank would generally be prepared to lend to an ESOP only on the security of the parent company's guarantee. There is also some doubt whether a company may make payments to such a trust in order for it to pay interest on and repay such borrowings. An extension of the exception to cover "financial assistance" would also remove this doubt.

Given our proposals on the tax side, I was interested to see the recent debate on the Companies Bill (ORHL 21 February 1989 Col 541-548), in which Lord Strathclyde said that the Government would consider bringing forward such an amendment in the Companies Bill as a matter of priority. I believe that such an amendment, with appropriate safeguards to prevent abuse, would be highly desirable. Furthermore, it would be helpful to make clear, when the tax changes are announced, that action is being taken to remove this unnecessary legal barrier to the development of ESOPs. Indeed, Nigel would probably wish to refer to it in his Budget Statement. If you are content, perhaps our officials could agree urgently a short reference that might be included.

Yours
Norman

NORMAN LAMONT

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL
DATE: 14 March 1989

MR NEILSON

cc
PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Painter)
Mr Lewis) IR
Mr Farmer)
Mr Kuczys)
PS/IR

ESOPs

The Financial Secretary had a word on the phone this morning with Mr Maude about his letter to Lord Young of 8 March. They agreed the following form of words for the Financial Secretary to use in his speech in the Budget Debate on the Companies Bill ESOPs question:-

> "my Right Honourable and Noble Friend, the Secretary of State for Trade and Industry, expects, if some technical difficulties can be resolved, to table amendments to this year's Companies Bill to relax this restriction."

This is as far as DTI Ministers are prepared to go, given their concern about the difficulties of framing suitable anti-abuse provisions to prevent the use of ESOPs in takeover situations. The section above will replace the last sentence in the second para of page 3 of Mr Kuczys' minute of 10 March (relevant extract attached).

R.C.M.S.

R C M SATCHWELL
Private Secretary

In addition to the specific corporation tax relief, the relaxation of the material interest test to which I referred earlier should also assist the introduction of this new kind of employee share ownership arrangements.

NB NOT YET CLEARED WITH DTI

I should underline that the Government has taken a comprehensive approach to dealing with the legislative barriers faced by ESOPs. Company law currently restricts the extent to which companies can give financial assistance to ESOP trusts. My rt hon and noble Friend, the Secretary of State for Trade and Industry, intends tabling amendments to this year's Companies Bill to remove this restriction.

Many claims have been made in support of ESOPs. By removing what was represented as the main obstacle to their development we hope that companies will now be encouraged to establish ESOPs in greater numbers than at present. In particular, companies which are perhaps unable or unwilling to introduce and operate the existing approved employee share schemes might, we hope, see this as the opportunity for extending share ownership to their employees too.

I stress that our underlying aim in making all these changes is to encourage arrangements which result in individual employees directly owning shares in the businesses in which they work.